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TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1937

No. 337

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

BANKLINE OIL COMPANY

No. 338

BANKLINE OIL COMPANY, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITIONS FOR CERTIORARI FILED SEPTEMBER 7, 1937

CERTIORARI GRANTED OCTOBER 25, 1937

No. 8294

United States
Circuit Court of Appeals
For the Ninth Circuit.

BANKLINE OIL CO., a corporation,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Transcript of the Record

Upon Petition to Review an Order of the United States Board of Tax Appeals.

PARKER PRINTING COMPANY, 549 SANSOME STREET, SAN FRANCISCO

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1937

No. 387

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

BANKLINE OIL COMPANY

No. 388

BANKLINE OIL COMPANY, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

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APPEARANCES.

For Taxpayer:
A. L. WEIL, Esq.,
HUGH C. BICKFORD, Esq.

For Comm'r:
GEORGE D. BRABSON, Esq.,
J. W. SMITH, Esq.

Docket No. 56484.

BANKLINE OIL COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DOCKET ENTRIES.

1931

Apr. 16—Petition received and filed. Taxpayer notified. (Fee paid)

" 16—Copy of petition served on General Counsel.

Jun. 1—Answer filed by General Counsel.

" 16—Copy served on taxpayer. Assigned to Circuit Calendar.

1934

Apr. 18—Hearing set week of July 2, 1934 at San Francisco, Calif.

1934

Jun. 6—Motion for leave to amend petition, amendment tendered, filed by taxpayer. 6/8/34 granted. 6/13/34 copy served.

Jul. 23—Hearing had before Mr. Logan Morris, Div. 14. Submitted on merits. Stipulation of facts filed. Analysis of contracts filed. Petitioner's brief due August 31, 1934—respondent's Oct. 15, 1934—petitioner's reply brief Oct. 31, 1934.

Aug. 10—Transcript of haring of July 23, 1934 filed.

" 28—Brief filed by taxpayer. 8/29/34 copy served.

Oct. 11—Brief filed by General Counsel.

" 26—Motion for leave to file answer to amended petition, amendment tendered filed by General Counsel.

" 29—Reply brief filed by taxpayer. 10/29/34 copy served.

" 29—Motion for leave to amend granted.

1936

Jan. 16—Findings of fact and opinion rendered, Logan Morris, Div. 14. Judgment will be entered under Rule 50.

Feb. 14—Notice of settlement filed by General Counsel.

" 17—Hearing set March 4, 1936 on settlement.

Mar. 4—Hearing had before J. E. Murdock, Div. 3 on settlement under Rule 50. Not contested. Referred to Mr. Morris for decision.

1936

Mar. 24—Decision entered, Logan Morris, Div. 14.
" 24—Consent to settlement filed by taxpayer.
" 26—Order that insofar as it pertains to docket 72502, decision entered March 24, 1936 is hereby vacated, entered.
Jun. 23—Supersedeas bond in the amount of $3000.00 approved and ordered filed.
" 23—Petition for review by U. S. Circuit Court of Appeals (9) with assignments of error filed by taxpayer.
" 23—Proof of service filed by taxpayer.
" 23—Statement of evidence lodged.
" 23—Notice of lodgment of statement and of hearing on July 8, 1936 to approve statement filed.
" 23—Praecipe with proof of service thereon filed. [1*]
Jul. 3—Notice of appearance of Hugh C. Bickford as counsel filed.
" 3—Motion for continuance to July 22, 1936 filed by taxpayer. 7/7/36 granted.
" 21—Agreed statement of evidence lodged.
" 21—Agreed statement of evidence approved and ordered filed. [2]

*Page numbering appearing at the foot of page of original certified Transcript of Record.

APPEARANCES.

For Taxpayer:
A. L. WEIL, Esq.,
HUGH C. BICKFORD, Esq.

For Comm'r:
GEORGE D. BRABSON, Esq.,
J. W. SMITH, Esq.

Docket No. 72502.

BANKLINE OIL COMPANY,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DOCKET ENTRIES.

1933

Jun. 5—Petition received and filed. Taxpayer notified. (Fee paid)

" 5—Copy of petition served on General Counsel.

Aug. 3—Answer filed by General Counsel.

" 12—Copy of answer served on taxpayer.

1934

Apr. 18—Hearing set for week of July 2, 1934 at San Francisco, Calif.

Jun. 6—Motion for leave to amend petition, amendment tendered, filed by taxpayer. 6/8/34 granted.

1934

Jul. 23—Hearing had before Mr. Morris, Div. 14 on merits. Stipulation of facts filed and analysis of contracts filed. Petitioner's brief due 8/31/34—Commissioner's brief due Oct. 15, 1934—petitioner's reply brief due Oct. 31, 1934.

Aug. 10—Transcript of hearing of July 23, 1934 filed.

" 28—Brief filed by taxpayer. 8/29/34 copy served.

Oct. 11—Brief filed by General Counsel.

" 18—Copy of amended petition served on General Counsel.

" 26—Motion for leave to file answer to amended petition filed by General Counsel. Oct. 29, 1934 granted.

" 29—Reply brief filed by taxpayer.

1936

Jan. 16—Findings of fact and opinion rendered, Mr. Morris, Div. 14. Judgment will be entered under Rule 50.

Feb. 14—Notice of settlement filed by General Counsel.

" 17—Hearing set March 4, 1936 on settlement.

Mar. 4—Hearing had before Mr. Murdock, Div. 3 on settlement under Rule 50—not contested—referred to Mr. Morris for decision.

" 24—Decision entered, Mr. Morris, Div. 14.

" 24—Consent to settlement filed by taxpayer.

1936

Mar. 26—Order that insofar as it pertains to Docket 72502, decision entered March 24, 1935 is hereby vacated entered.

" 28—Decision entered, Mr. Morris, Div. 14.

Jun. 23—Supersedeas bond in the amount of $3000.00 approved and ordered filed.

" 23—Petition for review by U. S. Circuit Court of Appeals (9) with assignments of error filed by taxpayer.

" 23—Proof of service filed by taxpayer.

" 23—Statement of evidence lodged.

" 23—Notice of lodgment of statement and for hearing on July 8, 1936 to approve statement filed.

" 23—Praecipe with proof of service thereon filed. [3]

Jul. 3—Notice of appearance of Hugh C. Bickford as counsel filed.

" 3—Motion for continuance to July 22, 1936 filed by taxpayer. 7/7/36 granted.

" 21—Agreed statement of evidence lodged.

" 21—Agreed statement of evidence approved and ordered filed. [4]

United States Board of Tax Appeals.

Docket No. 56484.

BANKLINE OIL COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

APPEAL.

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency IT:AR:E-3 dated February 20, 1931, and as a basis of its proceeding alleges as follows:

I.

That petitioner is a corporation organized under the laws of the State of California, with its principal office at No. 256 Montgomery Street, San Francisco, California.

II.

The notice of deficiency, a copy of which is attached and marked "Exhibit A", was mailed to petitioner as petitioner [5] is informed and believes on February 20, 1931.

III.

That the taxes in controversy are income taxes for the calendar years 1927 and 1928, there being an alleged deficiency of $8,903.92 for the year 1927, and $2,551.85 for the year 1928.

IV.

The determination of the tax set forth in said letter is based on the following errors, to-wit:

1. For the year 1927 the Commissioner has added to income the amount of $1,521.11 with the statement that "(a) Profit on sale of miscellaneous equipment credited against depreciation is restored to income." The petitioner claims the Commissioner has erred in increasing income by this amount, as the books of the company and the income tax return properly reflect the transactions involved in the sale of capital assets.

2. For the year 1927 the petitioner included as a deduction from income the amount of $373,185.97 under the caption of bad debts. The Commissioner has recomputed the loss to be $273,540.34, and has added to income the difference amounting to $99,645.63. The petitioner claims that the Commissioner has erred in disallowing the amount deducted as claimed in the income tax return.

3. The petitioner, in its 1927 income tax return, claimed depreciation on its casinghead gasoline plant at the rate of 16 2/3% per annum. The Commissioner has allowed 10%. The petitioner claims the Commissioner has erred in disallowing the 16 2/3%. [6] The question of the proper allowance for depreciation of the petitioner's casinghead gasoline plant is now before the Board of Tax Appeals, involving prior years. The petitioner claims that the depreciation on its oil well equipment in the Signal

Hill Oil Field should be computed on the unit basis, instead of at the rate of 10% per annum as allowed by the Commissioner. This matter is also now before the Board of Tax Appeals for prior years.

4. The petitioner, in the income tax return for 1927, claimed the deduction of $862.50 for commission paid in the year on lots sold in the year 1926. This deduction is disallowed by the Commissioner. As the amount was paid in the year 1927 the petitioner claims the Commissioner erred in disallowing the deduction.

5. The Commissioner has included as income in 1928 the amount of $1,605.54 for sale of assets. The petitioner claims this adjustment in the profit from sale of assets is in error and should not be added to income, as the amount of accrued depreciation as computed in the agent's schedule is in error, and not in agreement with the corrected accruals for depreciation.

6. The petitioner, in its income tax return for 1928, included as a deduction the amount of $2,441.00 paid the Government in the year in settlement of its capital stock tax of 1926. The petitioner claims this is an allowable deduction in the year 1928 and that the Commissioner erred in disallowing same and claiming it only a deduction for the year 1926. [7]

7. The petitioner, in its 1928 income tax return, claimed depreciation on its casinghead gasoline plant at the rate of 16 2/3% per annum. The Com-

missioner has allowed 10%. The petitioner claims the Commissioner has erred in disallowing the 16 2/3%. The question of the proper allowance for depreciation of the petitioner's casinghead gasoline plant is now before the Board of Tax Appeals involving prior years. The petitioner claims that the depreciation on its well equipment in the Signal Hill Oil Field should be computed on the unit basis, instead of at the rate of 10% per annum as allowed by the Commissioner. This matter is also now before the Board of Tax Appeals for prior years.

WHEREFORE petitioner prays that this Board may hear the proceeding and cancel the over-assessment.

A. L. WEIL
Counsel for Petitioner
310 Sansome Street
San Francisco, California

State of California
City and County of San Francisco—ss.

W. E. KROPP, being first duly sworn, deposes and says:

That he is the secretary of the petitioner; that he is duly authorized to verify the foregoing petition; that he has read the foregoing petition and is familiar with the statements contained therein; that the facts stated are true except as to those matters stated to be on information and belief, and as to those matters he believes it to be true.

W. E. KROPP

Subscribed and sworn to before me this 9th day of April, 1931.

LILLIAN RALSTON

Notary Public in and for the City and County of San Francisco, State of California. [8]

"EXHIBIT A"

TREASURY DEPARTMENT

Washington

Office of

Commissioner of Internal Revenue NP-2-26-28

Feb. 20, 1931.

Bankline Oil Company,
310 Sansome Street,
San Francisco, California.

Sirs:

You are advised that the determination of your tax liability for the years 1927 and 1928 discloses a deficiency of $11,455.77 as shown in the statement attached.

In accordance with section 274 of the Revenue Act of 1926 and section 272 of the Revenue Act of 1928, notice is hereby given of the deficiency mentioned. Within sixty days (not counting Sunday as the sixtieth day) from the date of the mailing of this letter, you may petition the United States Board of Tax Appeals for a redetermination of

your tax liability for the years in which a deficiency is disclosed.

HOWEVER, IF YOU DO NOT DESIRE TO PETITION, you are requested to execute the enclosed agreement form and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:C:P-7. The signing of this agreement will expedite the closing of your returns by permitting an early assessment of any deficiency and preventing the accumulation of interest charges, since the interest period terminates thirty days after filing the enclosed agreement, or on the date assessment is made, whichever is earlier; WHEREAS IF NO AGREEMENT IS FILED, interest will accumulate to the date of assessment of the deficiency.

Respectfully,
DAVID BURNET
Commissioner.
By (S) J. C. WILMER
Deputy Commissioner.

Enclosures:
Statement
Form 882
Form 870
Schedules 1 to 4, inclusive. [9]

STATEMENT.

IT:AR:E3
FCC-60D

In re: Bankline Oil Company,
310 Sansome Street,
San Francisco, California

TAX LIABILITY

Years	Tax Liability	Tax Assessed	Deficiency
1927	$ 8,903.92	None	$ 8,903.92
1928	52,122.90	$49,571.05	2,551.85
Totals	$61,026.82	$49,571.05	$11,455.77

The determination of tax liability shown herein is based upon reports of the revenue agent in charge at San Francisco, California, copies of which have been furnished you, and upon other data on file in this office.

Due to the fact that the statute of limitations will presently bar any assessment of additional tax against you for the years 1927 and 1928, the Bureau will be unable to afford you an opportunity under the provisions of article 1211 of Regulations 69 and/or article 451 of Regulations 74 to discuss your case before mailing formal notice of its determination as provided by section 274(a) of the Revenue Act of 1926 and/or section 272(a) of the Revenue Act of 1928. It is, therefore, necessary at this time to issue this formal notice of deficiency.

In the determination of tax liability shown herein, the statements made in your claim for the refund of $751.42 have been carefully considered. [10]

Bankline Oil Company Year ended December 31, 1927

SCHEDULUE 1

Net Income

Net loss as disclosed by return		$105,252.66
As corrected (net income)		65,954.94
Net adjustment		$171,207.60
Unallowable deductions and additional income:		
(a) Sale of equipment	$ 1,521.11	
(b) Adjustment of loss	99,645.63	
(c) Depreciation	75,378.55	
(d) Commission on lots sold	862.50	
Total		177,407.79
Nontaxable income and additional deductions:		
(e) Additional loss	$ 1,514.29	
f) Additional depletion	4,685.90	
Total		6,200.19
Net adjustment as above		$171,207.60

SCHEDULE 1-A

Explanation of Items Changed.

(a) Profit on sale of miscellaneous equipment, credited against depreciation is restored to income.

(b) The loss claimed on the notes of The Spring Company has been disallowed. It is held that this amount does not constitute a bad debt.

(c) Depreciation on absorption plant is allowed at the rate of 10% which this office holds to be an adequate return of the amount of wear and tear on this asset.

(d) Commission paid on lots sold in 1926 is not a proper charge against income of 1927.

(e) Due to adjustment of depreciation, an additional loss of $1,514.29 is allowed on Bethume lease.

(f) Depletion allowed	$110,436.28
Depletion deducted	105,750.38
Additional allowance	$ 4,685.90

[11]

SCHEDULE 2

Computation of Tax

Income Tax

Net income for taxable year	$65,954.94
Income tax at 13½%	8,903.92
Tax previously assessed	none
Additional tax to be assessed	$ 8,903.92

SCHEDULE 3

Year ended December 31, 1928.

Net Income

Net income as disclosed by return		$413,092.09
As corrected		434,357.54
Net adjustment		$ 21,265.45
Unallowable deductions and additional income:		
(a) Sale assets	$ 1,605.54	
(b) Capital stock tax	2,441.00	
(c) Depreciation	22,991.80	
Total		$ 27,038.34

Nontaxable income and additional deductions:		
(d) Loss by abandonment	$ 3,711.57	
(e) Depletion	2,061.32	
Total		$ 5,772.89
Net adjustment as above		$ 21,265.45

Explanation of Items Changed

(a) Profit on sale of miscellaneous equipment is added to income.

(b) Capital stock tax for 1926 is a proper charge against that year's income.

[12]

(c) Depreciation is adjusted as shown in exhibit "D" of revenue agent's report.

(d) Loss on abandonment of property is increased, due to adjustment of depreciation in prior years.

(e) Depletion allowed	$143,585.26
Depletion deducted	141,523.94
Additional deduction	$ 2,061.32

SCHEDULE 4

Computation of Tax

Income Tax

Net income for taxable year	$434,357.54
Income tax at 12%	52,122.90
Tax previously assessed	49,571.05
Additional tax to be assessed	$ 2,551.85

[Endorsed]: Filed Apr. 16, 1931. [13]

[Title of Court and Cause—Docket No. 56484.]

ANSWER.

The Commissioner of Internal Revenue, by his attorney, C. M. Charest, General Counsel, Bureau of Internal Revenue, for answer to the petition of the above-named taxpayer, admits and denies as follows:

(1) Admits the petitioner is a corporation organized under the laws of the State of California, with its principal office at San Francisco, California.

(2) Admits the allegations of paragraph II of the petition.

(3) Admits the allegations of paragraph III of the petition.

(4) Denies the respondent erred in the determination of the deficiencies as alleged in subparagraphs 1 to 7, inclusive, of paragraph IV of the petition, and further denies all the material allegations of fact contained therein.

Denies generally and specifically each and every allegation of the petition not hereinbefore admitted, qualified or denied.

WHEREFORE, it is prayed that the appeal be denied.

(Signed) C. M. CHAREST
General Counsel,
Bureau of Internal Revenue.

Of Counsel:
HENRY A. COX,
Special Attorney,
Bureau of Internal Revenue.

[Endorsed]: Filed June 1, 1931. [14]

[Title of Court and Causes—Docket Nos. 56484, 72502.]

MOTION FOR LEAVE TO FILE AMENDED PETITIONS

Comes now the above designated petitioner by and through its attorney, A. L. Weil, and moves the Honorable United States Board of Tax Appeals for leave to file the accompanying amended petitions in these cases and to substitute such petitions for the original petitions filed. The amended petitions should be accepted in order to permit the petitioner to submit evidence on the new issue involved in all of the above entitled cases in order to avoid irreparable injury which would be done if the petitioner's income tax cases were decided without giving consideration to the new issue which has not heretofore been raised in the pleadings.

The issue raised in the amended petitions, namely the right of the petitioner to depletion deductions on its interest in natural gas reserves under its casinghead gasoline contracts, is new to these proceedings. The fact that the petitioner was entitled to depletion on its interest in natural gas reserves was not known at the time the original petitions were filed. The petitioner is entitled to percentage depletion on its economic interest in oil and [15] gas wells acquired under its various casinghead gas contracts under the decision of the United States Supreme Court handed down January 9, 1933, in the case of Palmer vs. Bender, and under the terms of a

decision promulgated by the Honorable United States Board of Tax Appeals under date of April 27, 1934, in the case of Signal Gasoline Corporation vs. Commissioner of Internal Revenue. The respondent has knowledge of the fact that during each of the years involved in the above cases, the petitioner received substantial gross and net income from operations under its casinghead gas contracts, this information being set out by the Commissioner in determining the deficiencies which give rise to these proceedings.

WHEREFORE, it is respectfully requested that the motion be granted.

(Signed) A. L. WEIL
Counsel for Petitioner,
Higgins Building,
Los Angeles, California.

[Endorsed]: Filed June 6, 1934. Granted June 8, 1934. [16]

[Title of Court and Cause—Docket No. 56484.]

AMENDED PETITION

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency IT:AR:E-3 dated February 20, 1931, and as a basis of its proceeding alleges as follows:

1. That the petitioner is a corporation organized under the laws of the State of California, with its principal office at 256 Montgomery Street, San Francisco, California.

2. The notice of deficiency, a copy of which is attached and marked Exhibit A, was mailed to petitioner as petitioner is informed and believes on February 20, 1931.

3. The tax in controversy is income tax for the taxable periods and in the amounts shown below:

Taxable Period	Amount
Calendar year 1927	$8,903.92
Calendar year 1928	2,551.85
Total	$11,455.77

All of these amounts are in controversy. In addition, [17] petitioner seeks a refund of $37,202.13, for the calendar year 1928.

4. The determination of taxes set forth in said notice of deficiency is based upon the following errors:

(a) In determining taxable net income for each of the taxable years in question, the respondent erroneously disallowed deduction for depreciation of petitioner's depreciable property and equipment as follows:

Taxable Period	Amount
Calendar year 1927	$46,884.66
Calendar year 1928	26,548.70
Total	$73,433.36

(b) In determining taxable net income for the calendar year 1927, the respondent erroneously failed to allow as a deduction from gross income losses sustained on bad debts in the amount of $99,645.63.

(c) In determining taxable net income for each of the calendar years in question, respondent erroneously included as income, profits alleged to have been made on sales of miscellaneous equipment as follows:

Taxable Period	Amount
Calendar year 1927	$1,521.11
Calendar year 1928	1,605.54
Total	$3,126.65

(d) In determining taxable net income for the calendar year 1927, the respondent erroneously disallowed as a deduction from gross income, commission paid on a sale of real estate in the amount of $862.50. [18]

(e) In determining taxable net income for each of the years in question, the respondent erroneously failed to allow as deductions from gross income, depletion deductions to which petitioner is entitled as follows:

Taxable Period	Amount
Calendar year 1927	$109,176.14
Calendar year 1928	161,122.82
Total	$270,298.96

5. The facts upon which petitioner relies as a basis for this proceeding are as follows:

(a) During each of the years involved in this appeal petitioner operated a casinghead gasoline plant situate in the Signal Hill Oil Field in the County of Los Angeles, State of California. On the

portion of the plant that was completed prior to 1928 the question of depreciation has been in controversy in prior years from 1923 to 1926 inclusive, and by final decision of the Board of Tax Appeals on stipulation with the Commissioner in Bankline Oil Company vs. Commissioner of Internal Revenue, Docket Nos. 39424 and 41348, the proper amount of depreciation was fixed at 12½% per annum. This decision has been ignored by the Commissioner in computing depreciation for the years involved in this appeal and in lieu of computing depreciation at the allowable rate in determining taxable net income the respondent computed depreciation on the property in question at the rate of 10% per annum.

(b) During the year 1928 the petitioner erected a new unit on its casinghead gasoline plant at Signal Hill. Based on the prospective life of the properties under which the petitioner has gas contracts, it was estimated that the gas would be [19] exhausted in a period of six years. Accordingly the proper rate of depreciation on this property is 16-2/3% per annum. The respondent in error allowed depreciation on the property in question at the rate of only 10% per annum.

(c) During each of the years involved in this appeal, petitioner sustained depreciation on its oil well equipment situate in the Signal Hill Oil Field on the unit basis, which basis was established in settling petitioner's income tax controversies pending before the Board of Tax Appeals for the years 1923 to 1926 inclusive, as follows:

Taxable Period	Amount
Calendar year 1927	$40,647.54
Calendar year 1928	16,224.68
Total	$56,872.22

In determining petitioner's taxable net income for each of the years in question the respondent erroneously computed depreciation on said oil well equipment at the rate of 10% per annum, thus allowing depreciation for each of the years in question as follows:

Taxable Period	Amount
Calendar year 1927	$19,183.93
Calendar year 1928	24,665.71
Total	$43,849.64

(d) During the calendar year 1927 petitioner sustained a loss in the amount of $373,185.97 on uncollectible notes receivable. The respondent erroneously recomputed the loss to be $272,540.34 and disallowed as a deduction from gross income the difference amounting to $99,645.63. The loss claimed, amounting to $373,185.97, was actually sustained by petitioner [20] during the calendar year 1927 and should be allowed as a deduction from gross income in computing taxable net income.

(e) In rendering its tax returns for each of the years involved in this appeal the petitioner correctly reflected gains and profits realized on sales of miscellaneous equipment. In determining taxable income

for each of the years involved in this appeal the respondent made erroneous recomputations of accrued depreciation on miscellaneous items of equipment disposed of and as a result increased taxable income in the respective amounts of $1,521.11 and $1,605.54 for the years in question.

(f) Petitioner in its income tax returns for the year 1927 claimed a deduction in the amount of $862.50 for a liability incurred and paid as commission on various lots of real estate sold during the year 1926. The respondent disallowed this deduction.

(g) Prior to the year involved in this appeal petitioner acquired a depletable interest in certain natural gas reserves and natural gas producing property situate in the State of California, under the terms of various contracts commonly called casinghead gas contracts. Petitioner installed necessary pipe lines and equipment to enable it to obtain gas from its natural gas reserves and constructed an absorption plant for the purpose of removing gasoline from the natural gas. During the year involved in this appeal a substantial part of petitioner's operating income was attributable to the recovery of natural gas from its interest in gas reserves and the absorption of gasoline from such natural gas.

(h) During each of the years involved in this appeal petitioner is entitled to deduct from gross income in computing taxable net income percentage depletion in the amount of 27½ [21] percent of gross income, provided such amount does not exceed

50 percent of net income derived under casinghead gas contracts from its interest in natural gas reserves. During each of the years petitioner realized gross and net income from gas removed from such natural gas reserves and is entitled to depletion deductions as follows:

Taxable Year	Gross Income	Net Income	Allowable Depletion 27½ Percent of Gross Income	Allowable Depletion 50 Percent of Net Income
Calendar year 1927	$475,466.87	$218,352.28	$130,753.39	$109,176.14
Calendar year 1928	632,247.47	322,245.63	173,868.05	161,122.82

(i) In determining taxable net income for each of the years involved in this appeal respondent failed to deduct or to allow petitioner to deduct depletion from gross income in computing taxable net income.

WHEREFORE, the petitioner prays that this Board may hear the proceeding and determine that the respondent erred as alleged in paragraph (4) above, that the facts alleged in paragraph (5) above are true and correct, and that petitioner is entitled to refunds for the periods as set forth in paragraph (3) above.

(Signed) A. L. WEIL,
Counsel for Petitioner,
Higgins Building,
Los Angeles, California. [22]

AFFIDAVIT.

State of California,
City and County of San Francisco—ss.

W. E. KROPP, being first duly sworn, deposes and says: That he is the secretary of the petitioner; that he is duly authorized to verify the foregoing petition; that he has read the foregoing petition and is familiar with the statements contained therein; that the facts stated are true except as to those matters stated to be on information and belief, and as to those matters he believes it to be true.

(Signed) W. E. KROPP.

Subscribed and sworn to before me this 23rd day of May, 1934.

(Signed) LILLIAN RALSTON,
Notary Public in and for the City and County of San Francisco, State of California.

FOR SIXTY-DAY LETTER SEE ORIGINAL PETITION.

[Endorsed]: Lodged June 6, 1934.

[Endorsed]: Filed June 8, 1934. [23]

[Title of Court and Cause—Docket No. 56484.]

ANSWER TO AMENDED PETITION.

The Commissioner of Internal Revenue by his attorney, Robert H. Jackson, Assistant General Coun-

sel for the Bureau of Internal Revenue, for answer to the amended petition filed herein admits and denies as follows:

1. Admits the allegations contained in paragraph 1 of the petition.

2. Admits the allegations contained in paragraph 2 of the petition.

3. Admits the allegations contained in paragraph 3 of the petition.

4. Denies the allegations contained in subparagraphs (a), (b), (c), (d) and (e) of paragraph 4 of the petition.

5. Denies the allegations contained in subparagraphs (a) to (i), inclusive of paragraph 5 of the petition.

6. Denies generally and specifically each and every allegation of the petition not hereinbefore admitted, qualified or denied.

WHEREFORE, it is prayed that the appeal be denied.

(Signed) ROBERT H. JACKSON,
Assistant General Counsel for the
Bureau of Internal Revenue.

Of Counsel:
GEORGE D. BRABSON,
Special Attorney,
Bureau of Internal Revenue.
MFH 10/18/34.

[Endorsed]: Lodged Oct. 26, 1934.

[Endorsed]: Filed Oct. 29, 1934. [24]

[Title of Court and Cause—Docket No. 72502.]

APPEAL.

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency IR:AR:E-4 AMcM-60D, dated April 12, 1933, and for the allowance of a refund, and as a basis of its proceedings alleges as follows:

I.

That the petitioner is a corporation organized under the laws of the State of California, with its principal office at No. 256 Montgomery Street, San Francisco, California.

II.

That the notice of deficiency, a copy of which is attached and marked "Exhibit A" was mailed to petitioner as [25] petitioner is informed and believes on April 12, 1933.

III.

Taxes in controversy are income taxes for the calendar year 1930, there being an alleged deficiency of $5,811.67, and petitioner claims a refund of $21,255.57.

IV.

The determination of the tax set forth in said letter is based on the following errors:

(1) Depreciation on petitioner's casinghead gasoline plant at Signal Hill erected prior to 1928 is computed at the rate of 10% per annum, and should have been computed at the rate of 12½% per annum.

(2) The Commissioner erred in depreciating the equipment on State Permit No. 89 at 4% per annum, amounting to $12,612.05. Petitioner claims depreciation on a unit basis of $ .247344 per barrel, amounting to $89,335.93.

(4) Commissioner erred in depleting oil property on Section 36 at the rate of $ .02243 per barrel. Depletion should have been allowed at the rate of $ .13777, on which there should be an additional allowance for depletion of $4,190.75. [26]

(5) The Commissioner erred in disallowing an exemption from taxation of a net sum of $177,129.75, on which the tax was $21,255.57, on property produced from a lease held from the State of California.

V.

The facts on which petitioner bases his claim are as follows:

The petitioner operates a casinghead gasoline plant in the Signal Hill Oil Field in the County of Los Angeles, State of California. On the portion of the plant that was completed prior to 1928 the question of depreciation has been in controversy in prior years from 1922 to 1926, inclusive, and by final decision of the Board of Tax Appeals on stipulation with the Commissioner in Bankline Oil Company vs. Commissioner of Internal Revenue, Dockets Nos. 39424 and 41348, the proper amount of depreciation was fixed at 12½% per annum. This decision has been ignored by the Commissioner.

In the year 1928 the petitioner erected a new unit on its plant. Based on the prospective life of the

properties under which this petitioner had contracts, it was computed that the gas would be gone in six years, and the proper rate of depreciation is 16 2/3% per annum.

In the former appeals of the petitioner to the Board of Tax Appeals, in which final decision was rendered in Dockets [27] Nos. 39424 and 41348 on stipulation with the Commissioner the depreciation was allowed on a unit method. The depreciation at 4% allowed by the Commissioner amounts to $12,612.05. The method of depreciating fixed by the decision of the Board of Tax Appeals amounts to $ .247344 per barrel. The production for the year was 361,181 barrels. So depreciation allowed should have been $89,335.93.

In reference to Sec. 36 the depletion, instead of being at the rate of $ .0243 per barrel, should have been at the rate of $ .13777 per barrel. So that the depletion should have been $5,023.80. This is in accordance with a decision rendered by the Board of Tax Appeals in accordance with the Commissioner's stipulation.

The petitioner operates a lease in the Elwood area, County of Santa Barbara, State of California, issued by the State of California on tidelands below the high water mark. The State reserves a 5% royalty from the petitioner in the operation of this lease. The total net revenue derived from said lease during the year in question was $177,129.75. The petitioner paid a tax of $21,255.57 under protest, and in due time, as provided by law, made claim

for refund, which has been disallowed. Petitioner claims that said income is not subject to tax by the United States under a decision of the United States Supreme Court on the ground that said lease is an instrumentality of the State of California. [28]

WHEREFORE, petitioner prays that this Board may hear the proceedings, cancel the overassessment amounting to $5,811.67, and award petitioner a refund of $21,255.57, with interest.

A. L. WEIL,
Counsel for Petitioner,
310 Sansome Street,
San Francisco, California.

State of California,
City and County of San Francisco—ss.

W. E. KROPP, being first duly sworn, deposes and says:

That he is the secretary of the petitioner; that he is duly authorized to verify the foregoing petition; that he has read the foregoing petition and is familiar with the statements contained therein; that the facts stated are true except as to those matters stated to be on information and belief, and as to those matters he believes it to be true.

W. E. KROPP

Subscribed and sworn to before me this 26th day of May, 1933.

[Seal] LILLIAN RALSTON,
Notary Public in and for the City and County of San Francisco, State of California. [29]

EXHIBIT A.

TREASURY DEPARTMENT
Washington

Apr. 12, 1933.

Office of
Commissioner of Internal Revenue
Address Reply to
Commissioner of Internal Revenue
and refer to

Bankline Oil Company,
256 Montgomery Street,
San Francisco, California.

Sirs:

You are advised that the determination of your tax liability for the year(s) 1930 discloses a deficiency of $5,811.67, as shown in the statement attached.

In accordance with section 272 of the Revenue Act of 1928, notice is hereby given of the deficiency mentioned. Within sixty days (not counting Sunday as the sixtieth day) from the date of the mailing of this letter, you may petition the United States Board of Tax Appeals for a redetermination of your tax liability.

HOWEVER, IF YOU DO NOT DESIRE TO PETITION, you are requested to execute the inclosed form and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:C:P-7. The signing of this form will expedite the closing of your return(s) by permitting an early assessment of any deficiency and prevent-

ing the accumulation of interest charges, since the interest period terminates thirty days after filing the inclosed form, or on the date assessment is made, whichever is earlier; WHEREAS IF THIS FORM IS NOT FILED, interest will accumulate to the date of assessment of the deficiency.

Respectfully,
DAVID BURNET,
Commissioner.
By W. T. SHERWOOD,
Acting Deputy Commissioner.

Inclosures:
Statement
Form 870 [30]

IR:AR:E-4
AMcM-60D

STATEMENT.

In re: Bankline Oil Company
256 Montgomery Street,
San Francisco, California.
Income Tax Liability

Year—1930.
Income Tax Liability—$45,762.23.
Income Tax Assessed—$39,950.56.
Deficiency—$5,811.67.

The deficiency shown herein is based upon the report dated April 4, 1932 prepared by Internal Revenue Agent William J. Lyons and transmitted to you under date of April 13, 1932, which report is made a part of this letter.

Inasmuch as no evidence has been submitted in support of your contention that certain income from the operation of a lease held by you from the State of California is exempt from Federal income tax under article 642 of Regulations 74, your claim for refund of $21,255.57 for the year 1930 will be disallowed. Official notice of the disallowance of your claim will be issued by registered mail in accordance with section 1103(a) of the Revenue Act of 1932.

[Endorsed]: Filed June 5, 1933. [31]

[Title of Court and Cause—Docket No. 72502.]

ANSWER.

The Commissioner of Internal Revenue, by his attorney, E. Barrett Prettyman, General Counsel, Bureau of Internal Revenue, for answer to the petition of the above-named taxpayer, admits and denies as follows:

(1) Admits the allegations of paragraph I of the petition.

(2) Admits the allegations of paragraph II of the petition.

(3) Admits the allegations of paragraph III of the petition.

(4) Denies the respondent erred in the determination of the deficiency as alleged in subparagraphs (1) to (5), inclusive, of paragraph IV of the petition.

(5) Denies the allegations of fact contained in paragraph V of the petition.

Denies generally and specifically each and every allegation of the petition not hereinbefore admitted, qualified or denied.

WHEREFORE, it is prayed that the appeal be denied.

(Signed) E. BARRETT PRETTYMAN,
General Counsel,
Bureau of Internal Revenue.

Of Counsel:
HENRY A. COX,
T. A. DILS,
Special Attorneys,
Bureau of Internal Revenue.

HAC:TAD:I
8/1/33

[Endorsed]: Filed Aug. 3, 1933. [32]

[Title of Court and Cause—Docket No. 72502.]

AMENDED PETITION

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency IR:AR:E-4 AMcM-60D, dated April 12, 1933, and for the allowance of a refund, and as a basis of its proceedings alleges as follows:

1. That the petitioner is a corporation organized under the laws of the State of California, with its principal office at 256 Montgomery Street, San Francisco, California.

2. That the notice of deficiency, a copy of which is attached and marked Exhibit A was mailed to petitioner as petitioner is informed and believes on April 12, 1933.

3. The tax in controversy is income tax for the calendar year 1930, there being an alleged deficiency in the amount of $5,811.67. The entire amount is in controversy, and in addition petitioner seeks a refund in the amount of $33,710.32.

4. The determination of the tax set forth in said letter is based on the following errors:

(a) Depreciation on petitioner's casinghead gasoline plant at Signal Hill erected prior to 1928 is computed at the rate of 10% per annum, and should have been computed at the [33] rate of 12½% per annum.

(b) Depreciation on the plant erected in 1928 is computed on the basis of 10% per annum instead of at the rate of 16-2/3% per annum.

(c) The Commissioner erred in depreciating the equipment on State Permit No. 89 at 4% per annum, amounting to $12,612.05. Petitioner claims depreciation on a unit basis of $.247344 per barrel, amounting to $89,335.93.

(d) Commissioner erred in depleting oil property on Section 36 at the rate of $.02243 per barrel. Depletion should have been allowed at the rate of $.13777, on which there should be an additional allowance for depletion of $4,190.75.

(e) The Commissioner erred in disallowing an exemption from taxation of a net sum of

$239,299.88, on which the tax as computed amounted to $28,713.98, on income produced from a lease held from the State of California.

(f) In determining taxable net income for the calendar year 1930, the respondent erroneously failed to allow as deductions from gross income depletion deductions to which petitioner is entitled in the amount of $54,641.10.

5. The facts on which petitioner bases his claim are as follows:

(a) The petitioner operates a casinghead gasoline plant in the Signal Hill Oil Fields in the County of Los Angeles, State of California. On the portion of the plant that was completed prior to 1928 the question of depreciation has been in controversy in prior years from 1923 to 1926, inclusive, and by final decision of the Board of Tax Appeals on stipulation with the Commissioner in Bankline Oil Company vs. Commissioner of Internal Revenue, Docket Nos. 39424 and 41348, the proper [34] amount of depreciation was fixed at 12½% per annum. This decision has been ignored by the Commissioner.

(b) In the year 1928 the petitioner erected a new unit on its plant. Based on the prospective life of the properties under which this petitioner had contracts, it was computed that the gas would be gone in six years, and the proper rate of depreciation is 16-2/3% per annum.

(c) In the former appeals of the petitioner to the Board of Tax Appeals, in which final

decision was rendered in Docket Nos. 39424 and 41348 on stipulation with the Commissioner the depreciation was allowed on a unit method. The depreciation at 4% allowed by the Commissioner amounts to $12,612.05. The method of depreciating fixed by the decision of the Board of Tax Appeals amounts to $.247344 per barrel. The production for the year was 361,181 barrels. So depreciation allowed should have been $89,335.93.

(d) In reference to Sec. 36 the depletion, instead of being at the rate of $.0243 per barrel, should have been at the rate of $.13777 per barrel. So that the depletion should have been $5,023.80. This is in accordance with a decision rendered by the Board of Tax Appeals in accordance with the Commissioner's stipulation.

(e) The petitioner operates a lease in the Elwood area, County of Santa Barbara, State of California, issued by the State of California on tidelands below the high water mark. The State reserves a 5% royalty from the petitioner in the operation of this lease. The total net revenue derived from said lease during the year in question was $239,299.88. The petitioner paid a tax of $28,713.98 under protest, and in due time, as provided by law, made claim for refund, which has been disallowed. [35] Petitioner claims that said income is not subject to tax by the United States under a decision of the United States Supreme Court on the ground that said lease is an instrumentality of the State of California.

(f) Prior to the year involved in this appeal petitioner acquired a depletable interest in certain natural gas reserves and natural gas producing property situate in the State of California, under the terms of various contracts commonly called casinghead gas contracts. Petitioner installed necessary pipe lines and equipment to enable it to obtain gas from its natural gas reserves and constructed an absorption plant for the purpose of removing gasoline from the natural gas. During the year involved in this appeal a substantial part of petitioner's operating income was attributable to the recovery of natural gas from its interest in gas reserves and the absorption of gasoline from such natural gas.

(g) During the taxable year involved in this appeal petitioner is entitled to deduct from gross income in computing taxable net income percentage depletion in the amount of 27½% of gross income, provided such amount does not exceed 50% of net income derived under casinghead gas contracts from its interest in natural gas reserves. During the calendar year 1930 petitioner realized gross and net income under its casinghead gas contracts in the respective amounts of $300,017.99 and $109,282.21, and is entitled to a depletion deduction in the amount of $54,641.10 in computing taxable net income. Respondent failed to deduct or to allow petitioner to deduct any part of the depletion sustained on income derived under casinghead gas contracts from gross income in computing taxable net income for the year in question. [36]

WHEREFORE, the petitioner prays that this Board may hear the proceeding and determine that the respondent erred as alleged in paragraph (4) above, and that the facts alleged in paragraph (5) above are true and correct and that petitioner is entitled to a refund for the period as set forth in paragraph (3) above.

(Signed) A. L. WEIL
Counsel for Petitioner,
Higgins Building,
Los Angeles, California. [37]

AFFIDAVIT

State of California
City and County of San Francisco—ss.

W. E. KROPP, being first duly sworn, deposes and says: That he is the secretary of the petitioner; that he is duly authorized to verify the foregoing petition; that he has read the foregoing petition and is familiar with the statements contained therein; that the facts stated are true except as to those matters stated to be on information and belief, and as to those matters he believes it to be true.

(Signed) W. E. KROPP

Subscribed and sworn to before me this 23rd day of May, 1934.

(Signed) LILLIAN RALSTON
Notary Public in and for the City and County of San Francisco, State of California.

For sixty-day letter see original petition.

[Endorsed]: Lodged June 6, 1934.

[Endorsed]: Filed June 8, 1934. [38]

[Title of Court and Cause—Docket No. 72502.]

ANSWER TO AMENDED PETITION

The Commissioner of Internal Revenue by his attorney, Robert H. Jackson, Assistant General Counsel for the Bureau of Internal Revenue, for answer to the amended petition filed herein admits and denies as follows:

1. Admits the allegations contained in paragraph 1 of the petition.

2. Admits the allegations contained in paragraph 2 of the petition.

3. Admits the allegations contained in paragraph 3 of the petition.

4. Denies the allegations contained in subparagraphs (a) to (f), inclusive of paragraph 4 of the petition.

5. Denies the allegations contained in subparagraphs (a) to (g), inclusive, of paragraph 5 of the petition.

Denies generally and specifically each and every allegation of the petition not hereinbefore admitted, qualified or denied.

WHEREFORE, it is prayed that petitioner's appeal be denied.

(Signed) ROBERT H. JACKSON,
Assistant General Counsel
for the
Bureau of Internal Revenue.

Of Counsel:
GEORGE D. BRABSON,
Special Attorney,
Bureau of Internal Revenue.

[Endorsed]: Lodged Oct. 26, 1934.

[Title of Court and Causes—Docket Nos. 56484 and 72502.]

Promulgated January 16, 1936.

Income from a lease between the petitioner and the State of California is taxable under the principle of Burnet v. A. T. Jergins Trust, 288 U. S. 508.

Under the facts of this case petitioner has no depletable interest arising out of casinghead gas contracts. Signal Gasoline Corporation, 66 Fed. (2d) 886, distinguished.

A. L. WEIL, Esq., for the petitioner.

GEORGE D. BRABSON, Esq., for the respondent.

The respondent has determined deficiencies in income tax of $8,903.92, $2,551.85, and $5,811.67 for the taxable years 1927, 1928, and 1930, respectively, and the petitioner has brought these proceedings for the redetermination thereof, at the same time claiming overpayment for the latter year of $33,710.32.

Numerous issues were raised by the pleadings but those pertaining to depreciation, bad debts, profit upon the sales of miscellaneous equipment, commission paid upon the sale of real estate, and certain depletion (other than below) have been settled by stipulation of the parties, as hereinafter shown, leaving for our consideration only two issues, (1) whether the petitioner is totally exempt from income tax upon that portion of its income derived from a certain lease between the petitioner and the State of California, and (2) whether the petitioner is entitled to depletion growing out of its operations under so-called casinghead gas contracts.

FINDINGS OF FACT.

The petitioner, a corporation, organized and incorporated under the laws of the State of California, was engaged during each of the taxable years in controversy, and for many years prior thereto, in the business of producing oil from properties in which it owned an interest or in which it had acquired an interest as lessee, and also in the business of producing casinghead gasoline under the terms of various so-called "casinghead gas" contracts. For this latter purpose it maintained and operated, during each of said years, casinghead gasoline plant situated in the Signal Hill Oil Field, of Los Angeles, California. Its books of account were kept and its returns were filed on the accrual basis.

Under what is referred to by the parties as "Lease #89", dated October 22, 1929, the State of California leased certain oil and gas lands situated in the county of Santa Barbara, California, to J. H. Barneson, vice-president and director of the petitioner, who acted as agents for the petitioner, pursuant to the provisions of chapter 303, Statutes of California 1921, approved May 25, 1921, entitled "An Act to Reserve All Minerals in State Lands, etc." Barneson and his wife assigned all their right, title, and interest in said lease to the petitioner on November 14, 1929, and on December 19, 1929, the assignment was duly approved by the State of California.

The petitioner, upon acquiring the aforesaid lease, immediately commenced drilling operations, and since that date it has continuously operated in ac-

cordance with the provisions thereof. In rendering its income tax return for the calendar year 1930, the petitioner, under protest, included in its taxable net income the income attributable to its operations under that lease in the amount of $177,129.75. Due to changes in allowable depreciation and depletion the income attributable to the petitioner's operations under the lease would be reduced from $177,129.75, as reflected in its return, to $139,014.28. The petitioner realized net income from its operations under said lease, during the calendar year 1930, of $139,014.28.

Natural gas, commonly known as "wet gas", as it flows from the earth, is not a salable commodity. It is only through processing—by separation of the gasoline therefrom—rendering it dry, that it may be sold for commercial uses. Conversely, it is only through the separation of dry gas from wet gas that the gasoline is salable. It is this process that produces casinghead gasoline. The content of gasoline in wet gas varies from one-half gallon to six gallons a thousand cubic feet of gas produced, depending upon its richness.

In and prior to the taxable years the petitioner entered into numerous contracts with oil producers for the treatment of "wet gas" by the extraction of gasoline therefrom. Those contracts provided, generally, that the petitioner should install and maintain the necessary pipe lines and connections from casingheads or traps at the mouth of the well to its plant, through which the producer agreed to deliver to the petitioner's plant the natural gas produced at

such well, and that the petitioner should extract the gasoline therefrom, the petitioner to pay the producer 33-1/3 percent of the total gross proceeds derived from the sale of gasoline extracted from wet gas or, at the producer's option, therein provided, to deliver 33-1/3 percent of the salable gasoline, so extracted, to the producer. A slightly different type of such contract provided for the outright "purchase" from the producer of all natural gas produced at a given well, the petitioner paying 33-1/3 percent of the gross proceeds received by it from the sale of gasoline extracted from said gas. Some of the dry gas remaining after removal of the gasoline was blown to the air and wasted because there was no market for it, while some was sold to public utilities, in which case the petitioner accounted to the producer for a proportion of the proceeds provided for under the contract and some was returned to the wells to be used for pressure purposes.

The petitioner first raised the question of depletion under the casinghead gas contracts by amended petition.

OPINION.

Morris: The petitioner seeks total exemption of the income derived during the taxable year 1930 from "Lease #89", between itself and the State of California, under the doctrine of implied immunity, relying primarily upon Burnet v. Coronado Oil & Gas Co., 285 U. S. 393. The respondent, on the other hand, relies upon Burnet v. A. T. Jergins Trust, 288 U. S. 508.

Burnet v. Coronado Oil & Gas Co., supra, arose out of a lease entered into between the State of Oklahoma and Coronado Oil & Gas Co. "By the Enabling Act Congress required as a condition precedent to the admission of Oklahoma into the Union that her Constitution should make provision for common schools; and for their benefit it granted certain lands to the state with the proviso that those valuable for minerals, gas, and oil should not be sold prior to January 1, 1915, but might be leased. Act of June 16, 1906, 34 Stat. 267, 270, 272, 273. The State Constitution (article 11, §1) established a common school system and pledged her faith to preserve the lands so conveyed by the United States as a sacred trust, and to keep the same for the uses and purposes for which they were granted. The Legislature prescribed regulations for leasing and directing payment of the proceeds into the school fund." Burnet v. Coronado Oil & Gas Co., supra. Some of those lands were leased to Coronado Oil & Gas Co., by which the state was to, and did, receive a certain percentage of the gross production of oil and gas produced thereunder. The Court there held that the lease was an "instrumentality of the state for the purpose of carrying out her duty in respect of public schools."

In Burnet v. A. T. Jergins Trust, supra, the city of Long Beach, California, had acquired and held certain acreage for water supply purposes until, in 1922, oil was discovered in the vicinity thereof, when A. T. Jergins Trust was organized under the laws of California to obtain an oil and gas lease upon such lands. It was stipulated in such lease that

the city should receive 40 percent and A. T. Jergins Trust, 60 percent of the proceeds of oil and gas recovered. The taxpayer in that proceeding relied upon Gillespie v. State of Oklahoma, 257 U. S. 501 and Burnet v. Coronado Oil & Gas Co., supra. But the Court said, holding the income taxable, "In both of those cases the sovereign was acting as the trustee of an express trust with regard to the lands leased. In both the burden upon the public use was more definite and direct than in the present case. As said in the Coronado Case, the doctrine of Gillespie v. Oklahoma is to be applied strictly and only in circumstances closely analogous to those which it disclosed."

We find nothing, in principle, to distinguish the instant case from Burnet v. A. T. Jergins Trust, supra. The proposed tax is upon the net income of an independent private corporate entity from any and all sources, not upon the property of the municipality, upon its share of the oil recovered, the lease itself, nor the gross income therefrom. This income is just as remote from any governmental function as it was there. Certainly there is no close analogy between the circumstances of this case and those found in Burnet v. Coronado Oil & Gas Co., supra. Upon this issue we sustain the respondent's determination.

The petitioner alleges and contends that it is entitled to depletion under its casinghead gas contracts and in support of such contention it relies upon Signal Gasoline Corporation v. Commissioner, 66 Fed. (2d) 886, reversing the Board at 25 B. T. A. 861.

Sections 234 and 204 of the Revenue Act of 1926, applicable to allowable deductions and the basis for determining depletion, etc., are as follows:

Sec. 234. (a) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

* * * * * * *

(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;

* * * * * * *

Sec. 204 (c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—

* * * * * * *

(2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the

taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

The applicable provisions of the Revenue Act of 1928 are substantially the same as those of the Revenue Act of 1926 quoted above.

In Signal Gasoline Corporation, supra, the petitioner acquired a number of already existing casinghead gas contracts for which it assumed certain obligations, aggregating in excess of $50,000, and it paid cash of $107,488.41, and 450,000 shares of its common capital stock, par value $1.00 a share. There, as here, the petitioner, under its contracts—in many respects similar in terms to the contracts of this petitioner, but differing in many other vital respects—acquired wet gas from producers in the State of California. The contracts here are similar in their aims and objects but they differ widely in their scope of performance. The aims and objects, in both instances, were to produce wet gas and by a process of manufacture to render that wet gas a salable, useful commodity. They were similar in that the petitioner, in each instance, was to acquire, by purchase, leases, or otherwise all of the natural gas produced at a specified well for the purpose of extracting the gasoline therefrom and disposing of it, together with the dry gas—that is, such dry gas as was not consumed in the manufacture or blown to air, for the benefit of the parties concerned in pro-

portion to their contractual interests. In both cases the petitioner was required to lay the necessary pipe lines from the well to the absorption plant and, of course, such rights of ingress and egress as were necessary to the upkeep of such pipe lines were provided for. One noteworthy distinction, however, appears in the fact that in the instant case the producer, not the petitioner, was required to furnish necessary casingheads and gas traps to which the producer agreed to deliver the wet gas and from which the petitioner agreed to convey, through its pipe line, to its plant for treatment. In that case there appears to have been a much greater obligation on the part of the petitioner. Its duties respecting the production of gas did not cease with the delivery of wet gas to the casinghead or gas traps but it was required "whenever it became feasible and advisable, to install a vacuum upon the wells" and furthermore, "that it would install the necessary equipment and maintain such vacuum as was desired" by the producer "for regulating the pressure to be exerted in the operation." The petitioner there "assisted in drilling wells by furnishing separators, casing, derricks, boilers, other drilling equipment on the outcome of the well", for which it "received no payment, if the well was dry." Not only were the producers there bending their efforts toward the production and delivery of gas to the petitioner, but "producers and the petitioner were both engaged in continuous steps to win oil and casing-head gas from their position in the earth."

In that case "After a well had ceased flowing in commercial quantities from the natural pressure, it was necessary, in the case of most of the wells, for petitioner to take direct means by the introduction of high pressure dry gas into the well to induce a larger flow of oil and gas." In the instant case the petitioner was only required to return to the producer such quantity of gas as was necessary for injection purposes—it was required to take no "direct means" to bring about the production of gas—what means it took were indirect and merely incidental to its contractual obligation.

So much for the distinctions between the instant case and the case relied upon by the petitioner to support its claim. Let us examine a contract of this petitioner and see if we are able to find, as the court did there, that the interest of the petitioner was in the nature of a profit a prendre. Unless there was, of course, the petitioner would have no depletable interest. It is clear to our minds that it was intended by these contracts to establish an independent relationship between the parties, the producer, producing wet gas, on the one hand, and the manufacturer, converting that wet gas into salable commodities on the other. The preamble of this typical contract recites that the producer "is the owner of the natural gas produced" under that contract; that the petitioner has erected a plant for the extraction of gasoline; that in order to obtain "an adequate supply of gas for said plant" the petitioner "desires to receive from Producer all of the natural gas which may be produced" under such contract; that the

"Producer is desirous of having the gas produced" under that contract "treated for the extraction of gasoline therefrom", and "as an inducement to Bankline to operate a plant capable of treating the natural gas produced" the producer "is willing and desires to deliver to Bankline all of the natural gas produced."

The body of the contract repeatedly speaks in language of separate and independent obligations of the parties leaving not the slightest suggestion of an intention to create a right of profit a prendre. Speaking of this right, the court in Signal Gasoline Corporation, supra, said: "Considered by themselves, the contracts may not specifically convey any title to gas in the ground, but the contracts confer upon petitioner the right to enter upon the land and connect its pipes directly with the oil wells, install meters, and petitioner is required to maintain vacuums on the oil wells. These provisions, together with the method of operation sanctioned by the parties whereby petitioner, by means of gas lifts, rodless pumps, and the use of compressors to create vacuums, extracted the gas that would otherwise not be produced from the premises, conferred upon it an incorporeal right to be exercised in the land in relation to the gas which was in the nature of a grant of a profit a prendre." The only provision for the use of vacuum, found in only two of these contracts (there being seven), one of which, entered into between the petitioner and the General Petroleum Corporation on June 9, 1922, says:

> The first party [General Petroleum Corporation] hereby agrees to deliver to the second party [petitioner] at the traps or casing-heads of the wells in said Signal Hill District during the life of this agreement as hereinafter set forth, all gas which is now or which may be hereafter produced by the first party from any or all wells located in said Signal Hill District, and the said second party shall have the right to apply such vacuum if any as the first party shall hereafter indicate, and the vacuum to be applied to such wells may be changed from time to time as conditions in such wells warrant, but such change can only be made upon the sanction and consent in writing of said first party.

This provision, however, falls far short of establishing an absolute duty upon the petitioner or an absolute right in it to apply a vacuum without the approval of General Petroleum Corporation. At any rate there is really no proof of record that this contract, which was to continue so long as General Petroleum Corporation had available gas in the Signal Hill District, was actually in force during the years in question. Nor does the other contract in which it is provided for, dated March 23, 1926, alter our conclusion.

The court there was convinced that the contracts under consideration and the "methods employed in reducing the wet gas to possession" created "an interest in the gas in place or a right to share in the gas produced." It concluded that the petitioner

has the "requisite economic interest which under the statute entitled it to reasonable allowances for depletion." We are not so convinced.

There is not sufficient evidence for us to find here, as the court did there, that when the wells were drilled down to sand, only a small portion of the gas rose sufficiently to be caught in the casinghead, nor may we conclude from the evidence before us, as the court did, that "This would amount to such an insignificant quantity we would not have justified the erection of a plant to reduce it." There is some evidence of record from which we may conclude that difficulties were encountered from time to time in forcing the gas to the surface but we can not conclude that this difficulty was of such magnitude as the court there was able to find. Nor may we conclude, assuming the petitioner to have been cognizant of such factors at the outset, that it would not have installed such an extensive plant had not its contract with the producer granted it an interest in the mineral in place or assured it of a portion of the gross proceeds therefrom. It is safe to say, we believe, that this petitioner had no enforceable rights whatsoever under its contracts prior to the time the wet gas was actually placed in its pipe line, i. e., after it had passed beyond the casingheads and gas traps supplied by the producer and into the pipe line, except the right, perhaps, to demand that the producer deliver whatever was produced through its pipe lines for treatment during the period of contractual relationship.

Upon the record, the petitioner has wholly failed to establish depletable interest under the statute.

Even if all other facts, to which we have referred, pointed to a favorable conclusion for the petitioner we are of the opinion that the proof upon the subject of rates falls short of the mark for reasons which we need not discuss. See Lomita Gasoline Co., 33 B. T. A. 385.

Recomputation of the deficiencies, if any, should be in acordance herewith and the stipulation of the parties.

Reviewed by the Board.

Judgment will be entered under Rule 50.

Smith and Murdock concur in the result.

Trammell, Van Fossan, and Arnold dissent.

Black, concurring in the result:

I agree without reservation as to the first point. I concur in the result which has been reached in the majority opinion on the second point but I do so on the ground stated in the concluding paragraph of the opinion to the effect that petitioner has failed to show that the value of wet gas at the mouth of the well purchased under casinghead gasoline contracts was in excess of the royalties paid therefor and therefore has not shown any proper basis for depletion deductions. Signal Gasoline Corporation, 30 B. T. A. 568, affd. C. C. A., 9th Cir., 77 Fed. (2d) 778; Lomita Gasoline Co., 33 B. T. A. 385.

I do not concur in that part of the discussion in the majority opinion which holds that the casinghead gas contracts in the instant case are sufficiently different from those present in Signal Gasoline Corporation v. Commissioner, 66 Fed. (2d) 886, as to make the two cases distinguishable and to justify the holding in the majority opinion that petitioner in the instant case has no depletable interest arising out of the casinghead gas contracts. Petitioner's failure of proof to show what amount of depletion deductions, if any, it is entitled to take, appears to be similar to that in the cases above cited. As the court said in Signal Gasoline Corporation v. Commissioner, 77 Fed. (2d) 778, "Since the taxpayer is seeking a deduction for depletion from its otherwise taxable income, the burden of proof is upon it not only to prove that it is entitled to the deduction but also to prove the correct amount thereof."

Arundell and Leech concur in the above.

Copies served on both parties. [40]

United States Board of Tax Appeals

Docket Nos. 56484, 72502

BANKLINE OIL COMPANY,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION.

The above-entitled proceeding having been called from the Day Calendar of March 4, 1936 for hearing under Rule 50 pursuant to findings of fact and opinion promulgated January 16, 1936 and it appearing that respondent's recomputation for the years 1927 and 1928 stands uncontested by the petitioner, it is

ORDERED and DECIDED: That for 1927 there is a deficiency of $5,108.71, of which $3,592.88 has been paid; therefore there is now a deficiency for said year of $1,515.83, and it is further

ORDERED and DECIDED: That there is an overpayment for the year 1928 of $65.59, said tax having been paid within two years before the filing of the petition.

[Seal] (Signed) LOGAN MORRIS,
Member

Entered Mar. 24, 1936. [41]

[Title of Court and Cause.]

ORDER.

For cause, it is

ORDERED: That in so far as it pertains to Docket No. 72502, the decision entered March 24, 1936 in the above-entitled proceedings is hereby vacated.

[Seal] (Signed) LOGAN MORRIS,
Member.

Dated, Washington, D. C., March 26, 1936. [42]

United States Board of Tax Appeals

Docket No. 72502

BANKLINE OIL COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION.

The above-entitled proceeding having been called from the Day Calendar of March 4, 1936 for hearing under Rule 50 pursuant to findings of fact and opinion promulgated January 16, 1936 and it appearing that respondent's recomputation for the year 1930 stands uncontested by the petitioner, it is

ORDERED and DECIDED: That for 1930 there

is a deficiency of $846.94, of which $825.33 has been paid; therefore there is now a deficiency for said year of $21.61.

[Seal] (Signed) LOGAN MORRIS,
Member

Entered Mar. 28, 1936. [43]

[Title of Court and Cause.]

PETITION FOR REVIEW AND ASSIGNMENT OF ERRORS.

To the Honorable Judges of the United States Circuit Court of Appeals for the Ninth Circuit:

Comes now BANKLINE OIL COMPANY, a corporation, by its attorneys, A. L. Weil and Martin J. Weil, and respectfully shows:

I.

That petitioner is a corporation incorporated under and by virtue of the laws of the State of California, and files this petition pursuant to the provisions of the Revenue Act of 1926, C. 27, 44 Stat. 9, 109, 110, Sections 1001, 1002 and 1003, as amended by the Act of June 6, 1932, C. 209, Section 1101, 47 Stat. 286, as amended by the Act of June 7, 1934, C. 426, 48 Stat. 926, for review by this court of the decisions of the United States Board of Tax Appeals entered in Docket No. 56484 on March 24, 1936, and in Docket No. 72502 on March 28, 1936, determining that there existed deficiencies

in the tax payments of petitioner [44] in the amount of $5,108.71 for 1927 and $846.94 for 1930; and that there was an overpayment of tax of only the sum of $65.59 for the year 1928 and not an overpayment in the sum of $3,598.04 as contended by petitioner; and that petitioner was not entitled to a refund of $18,828.05, or any part thereof, for the year 1930, which said sum petitioner claims is an overpayment of tax.

These cases all related to the taxes of petitioner, and all involved the right of petitioner to deduct depletion growing out of contracts previously entered into by it for the extraction of casinghead gasoline. In addition to said issue, Docket No. 72502 involved the right of petitioner to exclude from its net income income received by it from property covered by an oil and gas lease in which the State of California was lessor. The cases were consolidated by the Board of Tax Appeals for hearing and decision.

II.

The nature of the controversy is as follows:

A. As to the issue relating to the taxability of income from its oil and gas lease from the State of California:

On October 22, 1929, the State of California leased certain oil and gas lands situated in the County of Santa Barbara, California, to H. J. Barneson, vice president and director of petitioner and agent of petitioner. Pursuant to the provisions of Chapter 303, Statutes of California, 1921, approved May 25,

1921, entitled "An Act to Reserve All Minerals in State Lands, etc.", Barneson and his wife assigned all of [45] their right, title and interest in said lease to petitioner on November 14, 1929, and the said assignment was approved by the State of California on December 19, 1929.

Petitioner operated wells drilled upon the said property and drilled additional wells. During the year 1930 petitioner realized a net income from its operations under said lease of $139,014.28.

The only issue on this point is whether or not such income is properly taxable.

B. As to the issue relating to the right of petitioner to take depletion on its casinghead gasoline contracts:

In 1922, petitioner entered into a contract with General Petroleum Corporation by which petitioner agreed to take wet gas produced from certain designated leases of General Petroleum Corporation and to extract the gasoline therefrom. As consideration for furnishing that wet gas, Bankline agreed to pay to General Petroleum Corporation 33 1/3% of all the gasoline extracted from the gas.

In 1923, petitioner entered into a contract with Superior Oil Company and three contracts with United Oil Company for the processing and treatment of their gas upon the same basis. In 1928, petitioner entered into a similar contract with Richfield Oil Company.

The amount of royalty which natural gas processors were required to pay to producers in order

to secure their gas increased from 33 1/3% in 1923 to 45% in 1927, 47½% in [46] 1928, and 50% in 1930.

The petitioner during all of these years received large quantities of wet gas from the wells operated by the aforesaid persons from which it extracted and received casinghead gasoline.

The amounts so received, the royalty paid, and the going royalty were as follows:

Year	Value of gasoline recovered	Contract royalty	Going royalty	Depletable interest
1927	626,494.68	208,831.67	281,922.61	73,090.94
1928	769,633.55	256,544.33	365,575.94	109,031.61
1930	390,596.48	130,257.68	195,298.24	65,040.56

III.

In the record and proceedings before the Board of Tax Appeals and in the decision and final order of re-determination rendered and entered by the Board of Tax Appeals, manifest error occurred and intervened to the prejudice of this petitioner, and petitioner assigns the following errors and each of them which, it avers, occurred in the said record, proceedings and decision and final order of re-determination rendered by the Board of Tax Appeals:

A. As to the issue relating to the taxability of income from its oil and gas lease from the State of California:

1. The Board erred in concluding as a matter of law that the income received by peti-

tioner as a result of its operations on lands owned by the State of California and leased to petitioner was a part of petitioner's income for purposes of [47] income tax and was not exempt from such income tax.

2. The Board erred in failing to find as a fact that petitioner had not erroneously paid taxes upon the sum of $139,014.28, being the net income received by petitioner as a result of its operations upon lands owned by the State of California and leased to petitioner.

3. The Board erred in holding that there was no overpayment of tax by petitioner for the year 1930.

4. The Board erred in failing to hold that petitioner had overpaid its taxes for 1930 in the sum of $16,681.71 because of its payment of taxes upon the income received by petitioner from its operations on lands owned by the State of California and leased to petitioner.

B. As to the issue relating to the right of petitioner to take depletion on its casinghead gasoline contracts:

1. The Board erred in failing to hold that petitioner was entitled to deduct the sum of $73,090.94 for depletion on its casinghead gasoline contracts for the year 1927.

2. The Board erred in failing to hold that petitioner was entitled to deduct the sum of

$109,031.61 for depletion on its casinghead gasoline contracts for the year 1928.

3. The Board erred in failing to hold that petitioner was entitled to deduct the sum of $65,040.56 for depletion on its casinghead gasoline contracts for the year 1930.

4. The Board erred in concluding as a matter of law that the contracts between petitioner and various producers to [48] extract casinghead gasoline produced by such producers with their oil, did not give to petitioner a depletable interest in the gas so produced when the going rate of royalty increased.

5. The Board erred in failing to hold that by virtue of the increase in the going rates of royalty upon casinghead gasoline contracts, petitioner under its casinghead gasoline contracts acquired a depletable interest measured by the difference between the royalty petitioner was required to pay and the royalty as determined by the going rate of royalty for the year in question.

6. The Board erred in holding in effect that there was no evidence to support a finding as to the amounts of depletion to which petitioner was entitled for the years 1927, 1928 and 1930, and each of them.

7. The Board erred in holding that there was a deficiency in petitioner's tax for the year 1927 in the sum of $5,108.71, or any part thereof.

8. The Board erred in holding that for the year 1928 petitioner had overpaid its taxes only to the extent of $65.59, and that petitioner had not overpaid its taxes in the sum of $3,598.04.

9. The Board erred in holding that there was a deficiency in petitioner's tax for the year 1930 in the sum of $846.94, and in failing to hold that there was an overpayment as a result of this issue in the sum of $2,146.34. [49]

WHEREFORE, your petitioner, Bankline Oil Company, petitions that the decisions of the Board of Tax Appeals be reviewed by the United States Circuit Court of Appeals for the Ninth Circuit; that a transcript of the record be prepared in accordance with law and the rules of said court and transmitted to the clerk of said court for filing; and that appropriate action be taken to the end that the errors complained of may be reviewed and corrected by said court.

Dated: June 19, 1936.

A. L. WEIL
MARTIN J. WEIL
Attorneys for Petitioner [50]

State of California
County of Los Angeles—ss.

E. J. CASE, being first duly sworn, deposes and says: That he is an officer, to-wit, Assistant Secretary, of petitioner Bankline Oil Company, and as such is duly authorized to verify the foregoing peti-

tion for review; that he has read said petition and is familiar with the contents thereof; that said petition is true of his own knowledge except as to the matters therein alleged on information and belief, and as to those matters he believes it to be true.

E. J. CASE.

Subscribed and sworn to before me this 19th day of June, 1936.

[Seal] (s) NINA M. BROCKUS,
Notary Public in and for the County of Los Angeles, State of California

[Endorsed]: Filed June 23, 1936. [51]

[Title of Court and Cause.]

NOTICE OF FILING PETITION FOR REVIEW

To Herman Oliphant, Esq., and
George D. Brabson, Esq.,
Bureau of Internal Revenue,
Washington, D. C.

You are hereby notified that Bankline Oil Company, petitioner in the above entitled action, did on the 23 day of June, 1936, file with the Clerk of the United States Board of Tax Appeals at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Ninth Circuit of the decision of the Board heretofore rendered in the above entitled case. A copy of

the petition for review and the assignment of errors as filed is hereby attached and served upon you.

A. L. WEIL
MARTIN J. WEIL
Attorneys for Petitioner.

Personal service of the above and foregoing notice, together with a copy of the petition for review and assignment of errors mentioned therein, is hereby acknowledged this 23rd day of June, 1936.

HERMAN OLIPHANT
Attorney for Respondent

[Endorsed]: Filed June 23, 1936. [52]

[Title of Court and Cause.]

STATEMENT OF EVIDENCE

The following is a statement of evidence in narrative form in the above entitled causes. These causes came on before the Honorable Logan Morris, Member of the United States Board of Tax Appeals in San Francisco, California, on July 23, 1934. A. L. Weil, Esq., appeared on behalf of the petitioner, and Robert H. Jackson, General Counsel of the Bureau of Internal Revenue, and George D. Brabson, Special Attorney, Bureau of Internal Revenue, appeared for the respondent.

(1)

The following stipulation covering all of the facts on all issues, but those upon the question of depletion upon casinghead gasoline contracts having previously been entered into by and between counsel for petitioner and counsel for the Government, was thereupon filed: [53]

"STIPULATION OF FACTS

"It is hereby stipulated and agreed by and between the parties hereto that the following facts are true and may be accepted by the Board as facts in arriving at its decision in this proceeding:

1. Petitioner is a corporation organized and existing under the laws of the State of California with its principal office at 256 Montgomery Street, San Francisco, California. For each of the calendar years 1927, 1928, and 1930, and for many years prior thereto, petitioner kept its books and filed its income tax returns on the accrual basis.

Depreciation

2. During each of the taxable years 1927, 1928, and 1930, and for many years prior thereto, petitioner was engaged in the business of producing oil from properties in which it owned an interest or had acquired an interest as lessee; it was also engaged in the business of producing casinghead gasoline under the terms of various casinghead gas contracts and for this purpose petitioner maintained and operated during each of the years mentioned

casinghead gasoline plants situated in the Signal Hill Oil Field in the City and County of Los Angeles, State of California. In rendering its income tax returns for the calendar years 1927, 1928, and 1930, petitioner claimed as deductions from gross income in computing taxable net income depreciation on its depreciable properties as follows: Calendar year 1927, $163,372.03, calendar year 1928, $131,-419.10, and calendar year 1930, $163,372.68. In determining the deficiency set forth in the respective notices of deficiency, the Commissioner allowed as deductions from petitioner's gross income in computing taxable net income depreciation on its said depreciable properties as follows: Calendar year 1927, $87,993.48, calendar year 1928, $108,427.30, and calendar year 1930, $135,429.78. It is agreed that petitioner suffered allowable depreciation on its said depreciable properties for each of the years involved in this proceeding as follows: Calendar year 1927, $132,225.89, calendar year 1928, $122,429.78, and calendar year 1930, $182,144.49, and that petitioner is entitled to deduct from gross income in determining taxable net income for the calendar years 1927, 1928, and 1930, depreciation in the respective amounts of $132,225.89, $122,429.78 and $182,144.49.

Depletion on Oil Properties

3. It is agreed that petitioner suffered allowable depletion on its interest in oil producing properties for each of the years [54] involved in this proceed-

ing as follows: Calendar year 1927, $110,413.93, calendar year 1928, $159,750.28, and calendar year 1930, $212,181.20, and that petitioner is entitled to deduct from gross income in determining taxable net income for the calendar years 1927, 1928 and 1930, depletion in the respective amounts of $110,413.93, $159,750.28, and $212,1881.20. The above agreed allowances for depletion do not include any depletion on petitioner's interest, if any, in oil and gas reserves under its various casinghead gas contracts. It is therefore agreed that if the Board should allow or find that petitioner is entitled to any percentage depletion on income obtained under said casinghead gas contracts that said depletion should be added to the above allowances for depletion on oil properties as above set forth. In determining the deficiency set forth in the respective notices of deficiency, the Commissioner allowed as deductions from petitioner's gross income in computing taxable net income for the calendar years 1927, 1928, and 1930, depletion on its interest in oil producting properties in the respective amounts of $110,436.28, $143,585.26 and $216,932.39. The Commissioner did not allow depletion on the petitioner's interest in oil and gas producing properties under its various casinghead gas contracts.

Profit on Equipment Sales

4. In determining the deficiency set forth in the notices of deficiency covering the calendar years 1927 and 1928, the Commissioner increased peti-

tioner's taxable net income as reported in its income tax returns for each of those years by adding thereto profits on sales of miscellaneous equipment as follows: Calendar year 1927, $1,521.11 and calendar year 1928, $1,605.54. It is agreed that said adjustments made by the Commissioner are correct.

Commission on Sales of Real Estate

5. In determining the deficiency set forth in the notice of deficiency covering the calendar year 1927, the Commissioner increased taxable net income as reported on petitioner's income tax return for that year in the amount of $862.50 by disallowing as a deduction from gross income commissions paid on sales of real estate amounting to $862.50. It is agreed that said adjustment made by the Commissioner is correct.

Losses on Notes Receivable

6. In rendering its income tax return for the calendar year 1927, petitioner claimed as a deduction from gross income in computing taxable net income a loss in the amount of $373,185.97 on uncollectible notes receivable. The Commissioner recomputed the [55] loss sustained on uncollectible notes receivable and allowed as a deduction from petitioner's gross income a loss in the amount of $273,-540.34, thus disallowing as a deduction from gross income the difference amounting to $99,645.63. It is agreed that petitioner suffered an allowable loss on said uncollectible notes receivable during the calen-

dar year 1927 in the amount of $273,540.34, and that the adjustment made by the Commissioner in disallowing $99,645.63 of the loss claimed in petitioner's tax return is correct.

Losses on Abandonment

7. In determining the deficiency set forth in the notice of deficiency covering the calendar years 1927 and 1928, the Commissioner allowed as deductions from gross income in computing taxable net income losses sustained on certain abandoned leases as follows: Calendar year 1927, $25,312.38, and calendar year 1928, $24,770.69. In determining said losses, the Commissioner did not take into consideration depreciation allowable on the abandoned development and equipment on the basis of the settlement of petitioner's income tax controversies for the calendar years 1923 to 1926, inclusive. Petitioner sustained losses on the aforesaid abandoned leases as follows: Calendar year 1927, $9,214.94, and calendar year 1928, $16,415.24, and losses previously allowed by the Commissioner on abandoned leases for the calendar years 1927 and 1928 should be reduced in the respective amounts of $16,087.44 and $8,355.45.

Losses on Sales of Equipment

8. Due to a revision of depreciation rates, losses on the sale of capital assets allowed by the Commissioner in his deficiency notice covering the calendar year 1930 should be reduced in the amount of $590.83.

9. It is agreed that the adjustments to petitioner's taxable income for the calendar years 1927, 1928 and 1930, as outlined in the preceding paragraphs numbered 1 to 8, inclusive, reduce petitioner's taxable net income as determined by Commissioner in his notices of deficiency as follows: Calendar year 1927, $28,112.62, calendar year 1928, $21,812.02, and calendar year 1930, $41,372.76.

Income from State Lease Number 89

10. Under date of October 22, 1929, the State of California leased certain oil and gas lands pursuant to the provisions of Chapter 303, Statutes of California 1921, approved May 25, 1921, entitled 'An Act to Reserve All Minerals in State Lands, etc.,' situated in the County of Santa Barbara, State of California, to H. J. Barneson. The lease in question is known as Lease #89 [56] and is referred to by the taxpayer as the Elwood Lease. Mr. H. J. Barneson was, on October 22, 1929, the vice-president and director of the petitioner corporation and in acquiring said lease from the State of California, he was acting for petitioner. Under date of November 14, 1929, H. J. Barneson and his wife, Nancy Lee Barneson, assigned all their right, title and interest in the aforesaid lease to Bankline Oil Company. The assignment was duly approved by the State of California under date of December 19, 1929.

11. The petitioner corporation, on acquiring the aforesaid lease immediately commenced drilling operations and since that date has continuously op-

erated in accordance with the provisions of said lease. In rendering its income tax return for the calendar year 1930, the taxpayer, under protest, included in its taxable net income income attributable to its operations under the aforesaid lease in the amount of $177,129.75. Due to changes in allowable depreciation and depletion above set forth, the income attributable to the taxpayer's operations under said lease would be reduced from $177,129.75 as reflected in its income tax return, to $139,014.28. It is agreed that taxpayer realized net income from its operation under said lease during the calendar year 1930 in the amount of $139,014.28. The determination of net income is reflected in Exhibit 1 which is attached to this Stipulation of Facts.

It is further agreed that either party may introduce additional evidence at the hearing before the Board, relating to the issues involved in this proceeding, and not inconsistent with the facts herein stipulated.

(Signed) A. L. WEIL,
Counsel for Petitioner,
Higgins Building,
Los Angeles, California.

(Signed) ROBERT H. JACKSON,
Assistant General Counsel for
the Bureau of Internal Revenue,
Counsel for the Respondent.

[57]

[Title of Court and Causes—Docket Nos. 56484, 72502.]

EXHIBIT 1.

STATEMENT SHOWING INCOME ATTRIBUTABLE TO OPERATIONS UNDER STATE LEASE NUMBER 89 DURING THE CALENDAR YEAR 1930.

Net income after deducting royalties		$537,859.88
Less expenses:		
Production expenses	$ 35,614.01	
Taxes	15,572.03	
Overhead	19,088.75	
Depreciation	89,335.93	
Drilling expenses	100,220.61	259,831.33
Net income before deducting depletion		$278,028.55
Less depletion 50% net income		139,014.27
NET INCOME FROM OPERATIONS UNDER THE PROVISIONS OF LEASE NUMBER 89, COVERING OIL LANDS OWNED BY THE STATE OF CALIFORNIA		$139,014.28

[58]

(2)

Statement of Evidence on the Issue Relating to the Right of Petitioner to Take Depletion Upon Casinghead Gasoline Contracts Held By It.

LLOYD AUBERT

being first duly sworn, testified on behalf of petitioner as follows:

I reside in Beverly Hills, California. I am General Manager of The Norwalk Company and the Bankline Oil Company.

(Testimony of Lloyd Aubert.)

There was thereupon introduced and received in evidence as petitioner's

EXHIBIT 1

a contract between Bankline Oil Company and Richfield Oil Company, dated October 9, 1928, reading as follows:

"AGREEMENT

THIS AGREEMENT, made and entered into this 9th day of October, 1928, by and between BANKLINE OIL COMPANY, a California corporation, hereinafter designated as 'Bankline', and RICHFIELD OIL COMPANY OF CALIFORNIA, a Delaware corporation, hereinafter designated as 'Producer',

WITNESSETH:

THAT, WHEREAS, Producer is the owner and/or lessee of those certain parcels of land, situate in the Signal Hill oil district, Los Angeles County, California, described as follows, to-wit:

Lots 3 to 9; Lots 16 to 20; Lots 25 to 29; Lots 35 to 48, all inclusive, in Block 12, Hillside Addition;

Lots 5 to 18, and Lots 27 to 48, both inclusive, in said Block 11, Hillside Addition, County of Los Angeles, State of California, as per map recorded in Book 10, at page 200 of Maps, Records of said county and state.

WHEREAS, producer is the owner and/or lessee of the above described premises and is the owner of

(Testimony of Lloyd Aubert.)

the natural gas [59] produced therefrom and hereby guarantees its right and title to same; and

WHEREAS, Bankline has erected and is operating a plant or plants in the Signal Hill Field for the purpose of treating gas for the extraction of gasoline therefrom; and

WHEREAS, Bankline, in order to obtain an adequate supply of gas for said plant or plants desires to receive from Producer all of the natural gas which may be produced from the above described property; and

WHEREAS, Producer is desirous of having the gas produced from the above described property treated for the extraction of gasoline therefrom; and

WHEREAS, Producer, as an inducement to Bankline to operate a plant capable of treating the natural gas produced from the above described property, is willing and desires to deliver to Bankline all of the natural gas produced on the above described property during the term of this agreement.

NOW, THEREFORE, in consideration of the premises, and of the covenants, agreements and payments hereinafter set forth and other valuable considerations, the receipt of which is hereby acknowledged, the parties hereto covenant and agree with each other as follows:

1. Producer hereby agrees to furnish and deliver to Bankline and Bankline agrees to take and utilize

(Testimony of Lloyd Aubert.)

in its plant or plants, subject to the terms and conditions of this agreement, natural gas produced from the above mentioned property during the life of this agreement except as provided in Paragraphs 7 and 8 hereof.

2. All gasoline condensed in the lines, pumps or traps of said Producer shall be considered as a part of the gas to be delivered to Bankline and shall be accounted for by Bankline as gasoline extracted from said gas.

3. Bankline is granted the exclusive right to treat gas produced from the above described property for and during the period of this agreement.

4. Producer shall deliver the gas at the casing-heads and/or at gas traps installed by Producer on the premises above described. Producer agrees to use its best efforts to prevent the inleakage of air in traps or lines. Bankline shall furnish, install and maintain all pipe lines and connections from casing-heads or traps to its plant or plants and such meters as may be necessary for the accurate measurement of the gas received from the property. [60]

5. The Producer, insofar as it has the right to do so, shall furnish rights of way for such pipe lines and connections on the property. Producer hereby grants to Bankline a right of way for its employees and vehicles over and across the lands of Producer hereinabove described for any and all purposes necessary or proper in connection with the business of Bankline insofar as it pertains to the functions to be performed by Bankline under the terms of this

(Testimony of Lloyd Aubert.)

agreement. Bankline shall be entitled to remove, within a reasonable time after the termination of this agreement, all pipe lines, connections, meters and other equipment installed by it.

6. In full consideration of the rights herein granted, Bankline agrees to pay to Producer thirty-three and one-third per cent (33-1/3%) of the total gross proceeds derived at the plant, from the sale of gasoline extracted from wet gas taken from the above described property, or at Producer's option, upon thirty (30) days advance notice in writing, Bankline agrees to deliver thirty-three and one-third per cent (33-1/3%) of the total net salable gasoline extracted from wet gas taken from the above described property to Producer in kind. An option once exercised to take the royalty gasoline either in cash or in kind shall not be changed for at least six (6) months unless agreed to by both parties hereto. In event no notice is given, royalty shall be deemed payable in money.

In the event no sale is made, at the plant, if said gasoline or Bankline uses the same in its refinery or other operations, Bankline agrees that the price of absorption gasoline for royalty settlement purposes hereunder shall be the average current market price offered for absorption gasoline of like quality by Bankline in the Signal Hill District. In event Producer is able to obtain a higher price for its royalty gasoline than is offered by Bankline, then Producer shall have the right, on twenty-four (24) hours written notice, to immediately exercise its

(Testimony of Lloyd Aubert.)

option to thereafter take its royalty gasoline in kind for a period of six (6) months as above set forth.

In event royalty gasoline shall be paid in kind, Bankline shall provide ten (10) days free storage of the royalty gasoline belonging to Producer in tanks provided by Bankline, provided, however, that such storage shall be at Producer's risk as to all loss by evaporation, fire and/or other causes beyond the reasonable control of Bankline.

Royalty payments shall be made by Bankline to Producer on or before the 20th of each calendar month next succeeding that in which the gasoline is produced.

7. It is understood that Producer is operating its property primarily for oil production and Bankline agrees to [61] handle the gas produced from Producer's property at pressures which, in the opinion of Producer, will not interfere with the production of oil from the leases. It is understood and agreed by and between the parties hereto that during the period of flush production or in event producer insists on maintaining extremely low pressures on casingheads or gas traps, Bankline shall entail no obligation to take, treat, or pay for gas produced and/or vented during such periods.

Bankline shall not be obligated to treat gas hereunder when the quantity of gas produced is so small as to render the treatment of same unprofitable to Bankline.

(Testimony of Lloyd Aubert.)

Such failure on the part of Bankline to treat gas because of the above mentioned conditions, shall in no manner serve or be considered a repudiation of this agreement by Bankline and all of the terms and conditions of this agreement shall be in effect upon resumption of normal operating conditions.

8. Bankline shall not be obligated to utilize any gas in its plant or plants which contains less than five-tenths (5/10) of a gallon of gasoline per one thousand (1,000) cubic feet of gas unless Bankline so desires. In the event Bankline shall refuse or neglect to take and utilize in its plant or plants any gas available on the above described property for the reason that the gasoline content of the gas is less than five-tenths (5/10) of a gallon per one thousand (1,000) cubic feet, Bankline agrees to use its best efforts and reserves the right to dispose of such gas in the same manner as provided for handling the residue dry gas from the plant or plants.

9. Bankline shall be entitled to treat at and by means of said plant or plants such quantities of gas as it may desire to take from other producers. Bankline shall meter separately the gas received from Producer and from other producers whose gas is so taken and at least twice a month shall test separately, according to a recognized method for testing gas, samples of gas received from Producer and from other producers. The amount of gasoline extracted from gas delivered by Producer shall be determined as a proportion of the total net gasoline extracted at

(Testimony of Lloyd Aubert.)

such plant or plants, computed from said meter readings and said tests.

10. Bankline agrees to return to Producer at the property line nearest to the existing dry lines of Bankline as much of the residue dry gas credited to Producer as may be necessary for fuel purposes and other producing activities of Producer on the said premises, provided, however, that Bankline shall not be obligated to deliver such gas at a pressure exceeding twenty (20) pounds per square inch at the plant of Bankline [62] making such delivery. It is understood and agred that Bankline may deliver dry gas to Producer in excess of the amount of residue dry gas credited to Producer, but in such event, Producer hereby agrees to pay Bankline for the excess dry gas delivered at the current market price of residue dry gas sold or delivered fom the plant of Bankline making such delivery to Producer, or in event Bankline, in order to meet the dry gas requirements of Producer, is required to purchase dry gas in the open market, then in this event, Producer agrees to reimburse Bankline for the excess dry gas furnished to Producer, at the same price Bankline is required to pay for same.

11. It is mutually understood and agreed that Bankline shall be entitled to use, free of charge, in its plant operations as much gas as it may require, provided, however, that in no event shall it be entitled to use, free of charge, (unless there be no market at the plant for such residue gas), an

(Testimony of Lloyd Aubert.)

amount of dry gas in its plant operations that is greater than twenty-five percent (25%) of the total volume of wet gas received from Producer. It is further mutually understood and agreed that Bankline, at its option, at such time or times as, in its opinion, conditions may warrant, shall be entitled to make a deduction from the quantity of wet gas furnished hereunder, of a certain volume of gas to cover shrinkage of the gas due to the extraction of the gasoline content therefrom; provided, however, that in no event shall the deduction to cover shrinkage of the gas be greater than fifty (50) cubic feet of gas for each gallon of gasoline extracted from gas furnished hereunder. Of the dry gas so computed to remain after the deductions have been made as described above for plant operations and shrinkage, Bankline shall currently return, upon demand of Producer, all or any part thereof to the above described property for use in the development and operation of same.

In the event that Producer does not require all of the gas to be returned for the above mentioned purposes, then Bankline will use its best efforts to sell the balance of the dry gas at the highest price which it can obtain. In the event of the sale of such residue dry gas by Bankline, Bankline shall pay unto Producer, on or before the 20th day of the next succeeding calendar month following that in which the sale occurs, fifty per cent (50%) of the total gross proceeds derived by Bankline from the sale of such residue dry gas, provided, however, that in

(Testimony of Lloyd Aubert.)

the event Bankline is not able to sell the resulting dry gas or for any other reason fails and/or neglects to sell the resulting dry gas, then in such an event Bankline shall be under no obligations whatsoever to Producer with respect to said dry gas.

12. Producer shall at all reasonable times during business hours have access to the accounts and records of Bankline insofar as they pertain to matters arising under this agreement or for the purpose of verifying statements made hereunder. [63]

13. Producer shall be entitled to require Bankline to test meters at intervals of at least once each month and oftener in event same is necessary. Producer shall have the privilege, if it so desires, of being present or having a representative present during all testing of the gas or the checking of meters registering the gas from the above described property.

14. Bankline agrees to furnish Producer with a report not later than the 20th of each month accounting for the gasoline produced and the dry gas returned for lease operations or sold. It is agreed that any and all objections to such reports must be made to Bankline in writing not later than fifteen (15) days after the receipt thereof by Producer, and that the failure by Producer to make such objection in writing within said period of fifteen (15) days shall create a conclusive presumption that such report is correct in all particulars, and that after said fifteen (15) day period shall have elapsed without any such written objections having

(Testimony of Lloyd Aubert.)

been made to Bankline, Producer shall not thereafter have the right to question or dispute such report in any way.

15. In the event that at any time or from time to time Bankline is required to pay any tax, license or governmental charge, directly or indirectly, upon that part of the gasoline manufactured from the gas of Producer to which Producer is entitled as royalty or upon the proceeds of the sale of such royalty gasoline, Producer shall reimburse Bankline for the full amount of such tax, license or governmental charge so paid by Bankline.

16. Bankline agrees to promptly pay, before the same become delinquent, all taxes which may be assessed or levied during the term of this agreement upon any property erected, placed or maintained by Bankline upon any of the lands of producer hereinabove described. In the event that Bankline fails so to do, Producer may pay any such tax, and Bankline shall reimburse Producer for all amounts so paid, with interest from the date of such payment at hte rate of ten per cent (10%) per annum, upon demand being made therefor.

17. Bankline shall not suffer any lien or liens to be filed against the plants, pipe lines, machinery and equipment, or any other property placed by Bankline upon the lands of Producer for work, labor, material or supplies furnished in connection therewith, and if any such lien or liens is filed thereon, Bankline agrees to remove the same at its own ex-

(Testimony of Lloyd Aubert.)

pense and cost and shall pay any judgments which may be entered thereon or thereunder. Should Bankline fail, neglect, or refuse so to do, Producer shall have the right to pay any amount required [64] to release any such lien or to defend any action brought thereon, and to pay any judgment entered therein, and Bankline shall be liable to Producer for all costs, damages and counsel fees, and any amounts expended in defending any proceedings or the payment of any of said liens or any judgment obtained therefor.

18. The non-performance by either party of its obligations hereunder shall be excused so long and only to the extent that such performance is prevented by strikes, delays of transportation companies, or other causes beyond the reasonable control of such party, whether similar or dissimilar to those above stated.

19. It is understood and agreed that in the determining of any question of fact or dispute as to any matter which may arise under this contract, the same shall be determined by a board of arbitrators to be composed of one member appointed by Producer and one member appointed by Bankline, and these two persons shall appoint a disinterested third person, and the decision of the majority of the board of arbitrators shall be binding upon both parties hereto. The decision of the arbitrators shall be a condition precedent to the right of action in this contract.

(Testimony of Lloyd Aubert.)

20. No provision of this contract shall be interpreted contrary to the rules and regulations of any regulatory body of the United States or of the State of California.

21. The term of this agreement shall be for five (5) years from and after the date hereof and so long thereafter as gas may be produced in paying quantities from the above described property.

22. In case of default by either party in the performance of its obligations hereunder, and the continuance of such default for thirty (30) days after written notice thereof, specifying the particulars of the default, the party not in default shall be entitled to terminate or suspend this agreement, and all rights and obligations hereunder shall thereupon cease and determine or be suspended accordingly.

23. All notices from Producer to Bankline shall be sent by United States Mail, postage prepaid, addressed to the Bankline Oil Company, Board of Trade Building, 111 West 7th Street, Los Angeles, California. All notices from Bankline to Producer shall be likewise sent by United States Mail, postage prepaid, addressed to Richfield Oil Company of California, Eleventh Floor, Bartlett Building, Seventh and Spring Streets, Los Angeles, California. Either party may change its mailing address to any other point within the State of California.

24. In so far as the land specifically above described is concerned, this contract wholly supple-

(Testimony of Lloyd Aubert.)

ments, supersedes, takes [65] the place of and forever cancels and renders null and void the following: That certain instrument headed "AGREEMENT, made and entered into the ninth day of June, 1922, by and between the General Petroleum Corporation, a California corporation, First Party, and Bankline Oil Company, likewise a California corporation, Second Party", it being understood that the Bankline Oil Company herein has heretofore treated and in the future intends to treat gas from the properties covered by said conract, the same being now owned by the Producer herein as successor to General Petroleum Corporation interests; and in further consideration of the execution hereof by Bankline Oil Company, the producer hereby releases, remises and forever quitclaims unto said Bankline Oil Company, and to its proprietary and subsidiary companies, all manner of actions and all premises, claims and debts of any kind and description at any time existing in connection with the operations and business conducted under and by virtue of said above described instrument, in so far as said land is concerned, in writing down to October 9th, 1928.

25. This agreement shall continue in force and be binding upon the parties hereto, their heirs, executors, administrators, successors, and assigns, for and during the term and period of this agreement.

(Testimony of Lloyd Aubert.)

IN WITNESS WHEREOF, the parties hereto have hereunto set their signatures and seals the day and year first above written.

BANKLINE OIL COMPANY,
By (s) H. J. BARNESON,
Vice President.
By (s) W. E. KROPP,
Secretary.

Approved
E. L. T.

RICHFIELD OIL COMPANY
OF CALIFORNIA,
By (s) J. G. WALLACE,
Vice President.
By (s) C. A. MADARY,
Secretary.

Approved 1928
(S) H. R. Linhoff

Approved
By (s) S. F. Arto. [66]

There was thereupon introduced and received in evidence as petitioner's

EXHIBIT NO. 2

a contract entered into between Bankline Oil Company and United Oil Company, dated October 25, 1923, reading as follows:

THIS AGREEMENT, made and entered into this 25th day of October, 1923, by and between THE

(Testimony of Lloyd Aubert.)

UNITED OIL COMPANY, a California Corporation, hereinafter designated as "Producer", and BANKLINE OIL COMPANY, a California corporation, hereinafter designated as "Bankline",

WITNESSETH:

THAT WHEREAS, the Producer is the lessee of the hereinafter described premises, generally known as the Jones Lease, under an oil and gas lease from Jonah & Lena B. Jones and John W. & Ora Hevener as lessors, dated July 21st, 1921, and recorded in Book 876, of Official Records, at page 174 thereof, records of Los Angeles County, California; and,

WHEREAS, Bankline has erected a plant in the Signal Hill District, in said County of Los Angeles, capable of handling and treating gas for the extraction of gasoline therefrom; and,

WHEREAS, the Bankline, in order to augment its supply of gas for said plant, desires to purchase and receive from said Producer all of the natural gas (except an aggregate total of three million standard cubic feet per day of twenty-four hours to be retained by Producer from the group of leases known as Denni No. 1, Denni No. 2, and Jones, for the operation of the Signal Hill Gasoline Company's plant) which may be produced from the property hereinafter described, for the purpose of manufacturing and extracting gasoline therefrom. It is expressly agreed that the Producer will install and maintain at its own expense a meter capable of accurately measuring the gas produced from the

(Testimony of Lloyd Aubert.)

property for the purpose of measuring the volume of gas retained by the Producer for the operation of the Signal Hill Gasoline Company's plant. Monthly statements shall be furnished by the Producer, to Bankline of the amount of gas so retained, and Bankline shall be entitled at all reasonable times to inspect said meter. Should any gas in excess of nine million cubic feet in any consecutive three days be reserved by the Producer, the Bankline may elect to immediately cancel this contract, and thereupon all its obligations hereunder shall cease, subject, [67] however, to the provisions of paragraph "14" hereof.

NOW, THEREFORE, in consideration of the mutual covenants herein contained, the parties hereto covenant and agree with each other as follows, to-wit:

1. The Producer hereby agrees to furnish and deliver to the Bankline, for the purpose of manufacturing and extracting gasoline therefrom, all of the gas (except such gas as is excepted above) for and during the entire period of time that gas shall be produced therefrom, the said Bankline being given the exclusive right to treat all gas produced as aforesaid by the Producer (except such gas as was excepted above); subject, however, to any qualifications set forth in paragraph "14" hereof.

2. The Producer shall deliver the gas at a modern and well equipped gas-trap, to be installed and maintained by the Producer at a central point on the premises hereinafter described. Bankline shall

(Testimony of Lloyd Aubert.)

furnish, install and maintain necessary pipe connections from said gas-trap to said plant, and one or more meters for the measurement of gas received at said plant. The connections and meters shall be available to inspection by the Producer at all reasonable times. The Producer shall furnish right of way for said pipe connection on the premises hereinafter described, and the Bankline elsewhere. The Bankline shall be entitled to remove on termination of this agreement all pipe connections, meters and other equipment installed by it.

3. In full consideration of the rights granted the Bankline agrees to pay to Producer one-third (33-1/3%) of the gross proceeds received by it from the sales of gasoline manufactured or extracted from said gas. Bankline shall have the right to sell royalty gasoline with its own share of the product and continue to do so if no election is made by the Producer to take his royalty gasoline in kind. Producer shall have the right to take his royalty gasoline in kind, provided he shall in such event serve Bankline with thirty days' advance notice in writing of such intention; and such election to take royalty gasoline in kind shall be exercised not oftener than once in every six calendar months.

In the event royalty gasoline is paid in kind, Producer shall be entitled to ten days' free storage of his royalty gasoline in tanks provided by Bankline, provided that such storage shall be at Producer's sole risk as to loss by evaporation, fire, or any other cause.

(Testimony of Lloyd Aubert.)

4. Royalty payments shall be made by Bankline to Producer on or before the 20th day of the calendar month next succeeding that in which gasoline is produced. [68]

5. The Producer shall have at all reasonable times during business hours, the right to inspect the records and accounts of the Bankline relating to the production of gasoline from said plant or plants. Bankline shall keep accurate records showing the amount of gas taken from the Producer's property, the gasoline content thereof as indicated by the tests hereinafter provided for, and full records of the amount of gas handled in said plant or plants, the quantity of gasoline produced and sold, and to whom sold, and the prices received therefor, the amount of gas consumed for fuel, and the amount of dry gas sold (if any be sold). Bankline shall have the right to use such gas for fuel out of the gas furnished by Producer as it may require in the operation of said plant or plants, provided, however, that such amount shall be taken in the proportion that the wet gas taken by the Bankline under this contract bears to the total amount of wet gas taken by it; and provided further, that the total amount taken by Bankline for fuel and allowed for wastage shall not exceed twenty-five per centum (25%) of the volume of wet gas received from the Producer.

6. Bankline shall be entitled to refine, at and by means of said plant or plants, such quantities of gas as it may desire to take from other persons than Producer. Bankline shall meter separately the

(Testimony of Lloyd Aubert.)

gas received from Producer and from other producers whose gas is so taken, and at least once a month shall test separately, according to a recognized method for testing gas, samples of gas received from Producer and from such other producers. The amount of gasoline extracted from gas delivered by Producer shall be determined as a proportion of the total gasoline extracted at said plant, computed from said meter readings and said tests. The Producer shall be entitled to require Bankline to test meters at intervals of not less than one month, on reasonable notice.

7. Bankline may elect not to receive any gas from Producer containing gasoline in lesser quantities than three-tenths (3/10) of a gallon per thousand cubic feet of gas; nor shall it be required to take gas at a pressure of less than thirty pounds per square inch.

8. Bankline agrees to use its best efforts to sell the dry gas remaining after gasoline content has been extracted, and in event of sale thereof it shall account to Producer, on the 20th day of the next calendar month following that in which sale occurs, on the basis, as to quantity, of at least seventy-five per cent. (75%) of the volume of wet gas delivered to it by Producer. In the event Producer elects to have dry gas returned to it, all expense of redelivery shall be borne by it, and it shall notify Bankline at least six months in advance of its election to take dry gas. For the purpose of allowing for loss and fuel used in Bankline's plant and lines there shall

(Testimony of Lloyd Aubert.)

be [69] no obligation on the part of Bankline to deliver dry gas to Producer in excess of seventy-five per cent (75%) of the volume of wet gas received by Bankline from Producer. In the event that the Producer does not elect to take such dry gas to which it is entitled at the Bankline plant, and such gas be not sold, then Bankline shall be under no obligations whatsoever to Producer as to such dry gas. ~~Any contracts for the sale of dry gas, extending over a period of more than ..... months, shall be subject to the approval of the Producer.~~

9. The property affected by this agreement is located in Los Angeles, County, California, and particularly described as follows:

> Lots Seven (7), Eight (8) and Nine (9) of Block "G", of Signal Hill, as per map thereof recorded in the office of the County Recorder of Los Angeles County, Book 9, pages 2 and 3 of Maps, in the Records of said County.

10. The performance by either party of his or its obligations hereunder shall be excused so long as and to the extent that such performance is prevented by strikes, lockouts, delays of transportation companies, inability to obtain necessary labor or material in the open market, or other causes beyond the reasonable control of such party.

11. In the event of any dispute as to any matter arising out of this agreement, such dispute shall be submitted to arbitration. Each of the parties hereto shall select one arbitrator and the two so selected shall select a third, and a decision by any two of

(Testimony of Lloyd Aubert.)

such arbitrators shall be binding and conclusive upon the parties hereto.

12. In case of default by either party in the performance of his or its obligations hereunder, and the continuance of such default for thirty (30) days after written notice thereof, specifying the particulars of the default, the party not in default shall be entitled to terminate this agreement, and all rights and obligations hereunder shall thereupon cease and determine except as to the payment to the Producer of any money which may be due to it from the Bankline.

13. All notices from the Producer to the Bankline hereunder shall be sent by United States mail, postage prepaid, addressed to the Bankline at 310 Sansome Street, San Francisco, California. All notices from the Bankline to the Producer shall be likewise sent by United States mail, postage prepaid, addressed to the Producer at A. G. Bartlett Building, Los Angeles, California. [70]

14. In the event that the quantity of gas produced from this property, together with production from other properties with the owners of which Bankline has contracts for the purchase of gas, exceed the capacity of the Bankline plant, or of the available capacity of such other plant or plants as may treat gas supplied by Bankline, then shall the Bankline be required to take a pro rata only of the gas produced from this property so that with a like pro rata from other parties with whom the Bankline

(Testimony of Lloyd Aubert.)

has contracts, the capacity of the plant will not be exceeded; provided, however, that the producer may retain for its own use, free from any further claim of the Bankline, any surplus of gas supplied under this contract and any other of its contemporaneous contracts with Bankline, and for a consecutive period of thirty days at any time during the life of this contract not accepted and used by Bankline.

15. United agrees to indemnify and hold harmless the Bankline against all claims and demands of the lessors, holders of royalty interest, and/or F. N. Rumbley and/or their heirs or assigns, arising out of any act or omission of the Bankline under this agreement.

This agreement shall be binding upon and inure to the benefit of the heirs, successors and assigns of the respective parties hereto.

Executed in duplicate the day and year first hereinabove written.

THE UNITED OIL COMPANY

(Seal)
(UOCo)

By (s) C. F. WHITTIER
President

By (s) J. G. WALLACE
Secretary

BANKLINE OIL COMPANY

By (s) A. L. WEIL
Vice Pres.

By (s) R. C. PETERSON
Secretary

(Testimony of Lloyd Aubert.)

October 25th, 1923.

IN CONSIDERATION of the payment to it of the sum of Ten Dollars ($10.00) lawful money of the United States, the receipt of which is hereby acknowledged, the SIGNAL HILL GASOLINE COMPANY, a California corporation, does hereby cancel and surrender all rights and privileges; [71]

(a) Under that certain agreement dated May 23, 1922, between UNITED OIL COMPANY and SIGNAL HILL GASOLINE COMPANY; and

(b) Any and all rights which it may possess by virtue of any other contracts or agreements with UNITED OIL COMPANY relating to gas produced from any of the properties of the UNITED OIL COMPANY in the Signal Hill District;

Which interfere or may in the future interfere or be in conflict with any of the provisions of the foregoing contract between UNITED OIL COMPANY and BANKLINE OIL COMPANY, to which last mentioned contract this joinder is a part;

And United Oil Company hereby releases Signal Hill Gasoline Company from all obligations in conflict herewith.

SIGNAL HILL GASOLINE COMPANY

(Seal) By (s) R. V. KERTON
Pres.

By (s) J. G. WALLACE
Secy.

UNITED OIL COMPANY

(Seal) By (s) C. F. WHITTIER
Pres.

By (s) J. G. WALLACE
Secy.

(Testimony of Lloyd Aubert.)

There was thereupon introduced and received in evidence as petitioner's

EXHIBIT NO. 3

a contract between Superior Oil Company and Bankline Oil Company, dated May 25, 1925, reading as follows:

THIS AGREEMENT, made and entered into this 25th day of May, 1925, by and between THE SUPERIOR OIL COMPANY, a corporation, duly organized and existing under and by virtue of the laws of the State of California, hereinafter designated as "Producer", and BANKLINE OIL COMPANY, California corporation, hereinafter designated as "Bankline",

WITNESSETH:

THAT WHEREAS, the Producer is the lessee of the hereinafter described premises, under an oil and gas lease from ROBT. H. BRITTON, MATTIE E. BRITTON, et al, as lessor, dated Mar. 28, 1922, and recorded in Book 1134 of ....., at page 238 thereof, records of Los Angeles County, California, and, [72]

WHEREAS, Bankline has erected a plant in the Signal Hill District, in said County of Los Angeles, capable of handling and treating gas for the extraction of gasoline therefrom; and,

WHEREAS, the Bankline, in order to augment its supply of gas for said plant, desires to purchase and receive from said Producer all of the natural

(Testimony of Lloyd Aubert.)

gas (except such gas as may be required in the development and operation of the property), which may be produced from the property hereinafter described, for the purpose of manufacturing and extracting gasoline therefrom;

NOW, THEREFORE, in consideration of the mutual covenants herein contained, and other good and valuable consideration, the receipt of which is hereby acknowledged, the parties hereto covenant and agree with each other as follows, to-wit:

1. The Producer hereby agrees to furnish and deliver to the Bankline, for the purpose of manufacturing and extracting gasoline therefrom, all of the gas produced on the lease (except such gas as may be required in the development and operation of the property, which it is understood may be retained by Producer if he so desires) for and during the entire period of time that gas shall be produced therefrom, the said Bankline being given the exclusive right to treat all gas produced as aforesaid.

2. The Producer shall deliver the gas at an approved gas-trap, to be installed and maintained by the Producer at a central point on the premises hereinafter described, and Bankline agrees to carry such vacuum or pressure at this point as Producer shall from time to time deem advisable. Bankline shall furnish, install and maintain necessary pipe connections from said gas trap to said plant, and necessary meter or meters for the measurement of gas delivered from said premises. The Producer

(Testimony of Lloyd Aubert.)

shall furnish right of way for said pipe lines and connections on the premises hereinafter described, and the Bankline elsewhere. The Bankline shall be entitled to remove on termination of this agreement all pipe connections, meters and other equipment installed by it.

3. In full consideration of the rights herein granted the Bankline agrees to pay to Producer one-third (33-1/3%) of the gross proceeds received by it from the sales of gasoline manufactured or extracted from said gas. Bankline shall have the right to sell royalty gasoline with [73] its own share of the product and continue to do so if no election be made by the Producer to take his royalty gasoline in kind. Producer shall have the right to take his royalty gasoline in kind, provided he shall in such event serve Bankline with thirty days' advance notice in writing of such intention, and such election to take royalty gasoline in kind shall be exercised not oftener than once in every six calendar months.

In the event royalty gasoline be paid in kind, producer shall be entitled to thirty days free storage of his royalty gasoline in tanks provided by Bankline, provided that such storage shall be at Producer's sole risk as to loss by evaporation, fire, or any other cause.

4. Royalty payments shall be made by Bankline to Producer on or before the 20th day of the calendar month next succeeding that in which gasoline is produced.

(Testimony of Lloyd Aubert.)

5. The Producer shall have at all reasonable times during business hours, the right to inspect the records and accounts of the Bankline relating to the production of gasoline from said plant or plants. Bankline shall keep accurate records and furnish the Producer with a statement thereof, showing the amount of gas taken from the Producer's property, the gasoline content thereof as indicated by the tests hereinafter provided for, and full records of the amount of gas handled in said plant or plants, the quantity of gasoline produced and sold, and the prices received therefor, the amount of gas consumed for fuel, and the amount of dry gas sold (if any be sold). Bankline shall have the right to use such gas for fuel out of the gas furnished by Producer as it may require in the operation of said plant or plants in which Producer's gas is utilized. The amount of gas wasted or used for fuel shall be apportioned against the various producers on the basis of the quantities delivered to the plant.

6. Bankline shall be entitled to refine, at and by means of said plant or plants, such quantities of gas as it may desire to take from other persons than Producer. Bankline shall meter separately the gas received from Producer and from other producers whose gas is so taken, and at least once a month shall test separately, according to a recognized method for testing gas, samples of gas received from Producer and from such other producers. The amount of gasoline extracted from gas delivered by

(Testimony of Lloyd Aubert.)

Producer shall be determined as a proportion of hte total gasoline extracted at said plant, computed from said meter readings and said tests. The producer shall be entitled to require Bankline to test meters at intervals of not less than one month on reasonable notice. [74]

7. Bankline agrees to maintain sufficient vacuum on its lines at all times to handle all gas produced on the lease or leases, but may elect not to receive any gas from Producer which does not contain gasoline in commercial quantities. Any gas tendered to Bankline under this agreement and rejected by them may be disposed of elsewhere by Producer.

8. Bankline agrees to use its best efforts to sell the dry gas remaining after gasoline content has been extracted, and in event of sale thereof it shall account to Producer, on the 20th day of the next calendar month following that in which sale occurs, on the basis, as to quantity, of at least seventy-five per cent. (75%) of the volume of wet gas delivered to it by Producer. Bankline agrees to pay to Producer for all dry gas sold the entire gross proceeds of such sale, less the actual cost of compressing and marketing the same, in any event not to exceed four cents (4¢) per M. cubic feet. In the event Producer elects to have dry gas returned to him, the same shall be returned at a pressure of at least 25 pounds per square inch at the plant, but all expense of redelivery shall be borne by him. For the purpose of allowing for loss and fuel used in Bankline's plant and lines there shall be no obligation on the part of

(Testimony of Lloyd Aubert.)

Bankline to deliver dry gas to Producer in excess of seventy-five per cent. (75%) of the volume of wet gas received by Bankline from Producer. In the event that the Producer does not elect to take such dry gas to which it is entitled at the Bankline plant, and such gas be not sold, then Bankline shall be under no obligations whatsoever to Producer as to such dry gas.

9. The property affected by this agreement is located in Los Angeles County, California, and particularly described as follows:

Lots Eighteen and Nineteen Block forty-eight (48) East one-half (E½) of Lot Eighteen (18) and West one-half (W½) of Lot Seventeen (17) of Block Forty-three (43), Peck & Anderson Tract, Los Angeles County, as per map recorded in Book 4, Page 11, containing 3 acres.

Lots one (1), two (2), three (3), four (4) and five (5), Block Forty-three (43); P. & A. Tract, containing 5 acres.

East one-half (E½) Lot seventeen (17) and Lot Sixteen (16), Block Forty-three (43) P. & A. Tract, containing 1½ acres. [75]

10. The performance by either pary of his or its obligations hereunder shall be excused so long as and to the extent that such performance is prevented by strikes, lockouts, delays of transportation companies, inability to obtain necessary labor or material in the open market, or other causes beyond the reasonable control of such party.

(Testimony of Lloyd Aubert.)

11. In the event of any dispute as to any matter arising out of this agreement, such dispute shall be submitted to arbitration. Each of the parties hereto shall select one arbitrator and the two so selected shall select a third, and a decision by any two of such arbitrators shall be binding and conclusive upon the parties hereto.

12. In case of default by either party in the performance of his or its obligations hereunder, and the continuance of such default for thirty (30) days after written notice thereof, specifying the particulars of the default, the party not in default shall be entitled to terminate this agreement, and all rights and obligations hereunder shall thereupon cease and determine except as to the payment to the Producer of any money which may be due to it from the Bankline.

13. All notices from the Producer to the Bankline hereunder shall be sent by United States mail, postage prepaid, addressed to the Bankline at 310 Sansome Street, San Francisco, California. All notices from the Bankline to the Producer shall be likewise sent by United States mail, postage prepaid, addressed to the Producer at 1203 A. G. Bartlett Building, Los Angeles, California.

This agreement shall be binding upon and inure to the benefit of the heirs, successors and assigns of the respective parties hereto.

(Testimony of Lloyd Aubert.)

Executed in duplicate the day and year first hereinabove written.

THE SUPERIOR OIL COMPANY

(Seal) By (s) W. M. Keck

Pres.

And F. D. JONES

Asst. Secy.

BANKLINE OIL COMPANY

By

And

We, the undersigned, lessors in that certain lease above mentioned (or present owners of the property above de- [76] scribed or having an interest in the royalties or production therefrom) do hereby join in the foregoing contract in so far as our royalty gas, if any, is concerned; all payments to us to be made to ..... Such payments shall relieve Bankline Oil Company from seeing to the proper distribution thereof.

Dated ....., 1925.

.....

.....

There was thereupon introduced and received in evidence as petitioner's

EXHIBIT NO. 4

a contract between United Oil Company and Bankline Oil Company, dated October 25, 1923. Said contract was in the same words and figures as peti-

(Testimony of Lloyd Aubert.)

tioner's Exhibit No. 2, except that the said contract referred to the so-called Denni Lease No. 2, and the property from which said gas was to be taken was specifically described and different from the property described in Exhibit No. 2.

There was thereupon introduced and received in evidence as petitioner's

EXHIBIT NO. 5

a contract between United Oil Company and Bankline Oil Company, dated October 25, 1923. Said contract was in the same words and figures as petitioner's Exhibit No. 2, except that the said contract referred to the so-called Malcolm Davis Lease, and the property from which said gas was to be taken was specifically described and different from the property described in Exhibit No. 2. [77]

There was thereupon introduced and received in evidence as petitioner's

EXHIBIT NO. 6

a contract between General Petroleum Corporation and Bankline Oil Company, dated June 9, 1922, reading as follows:

THIS AGREEMENT, made and entered into this 9th day of June, 1922, by and between the GENERAL PETROLEUM CORPORATION, a corporation organized and existing under and by virtue of the laws of the State of California, hereinafter called the first party, and the BANKLINE

(Testimony of Lloyd Aubert.)

OIL COMPANY, likewise a California corporation, hereinafter called the second party,

WITNESSETH:

That, whereas, the first party is the holder and owner of certain leases in what is known as the Signal Hill District, and,

Whereas, first party desires to sell and second party desires to buy upon a royalty basis the gasoline which may be extracted from the gas produced by the first party from said lands in the Signal Hill District;

Now, therefore, in consideration of the sum of Ten ($10.00) Dollars each to the other in hand paid, receipt of which is hereby acknowledged, and the faithful performance of the covenants hereinafter expressed, it is agreed as follows:

First: The party of the second part will erect, equip, maintain and operate upon what is known as the Jasper Lease, being the east six hundred and sixty (660') feet of the north six hundred and thirty (630') feet of Block sixty-four (64), American Colony Tract, as per map recorded in Book nineteen (19) Page eight (8), Miscellaneous Records of Los Angeles County, a plant or plants for the recovery of gasoline from casing-head gas, and will lay, maintain, remove and replace any and all pipe necessary to the operation of said plant or plants. However, the erection, operation and maintenance of said plant or plants shall in no manner interfere

(Testimony of Lloyd Aubert.)

with the proper and efficient working or development of said lands above described, nor any part thereof, by the said first party, for the production of oil therefrom.

Second: The said party of the second part agrees to immediately commence preparation for the erection, maintenance and operation of an absorption plant for extracting the gasoline from [78] the natural or casing-head gas produced by said party of the first part in said Signal Hill District, and to complete the same and have it in operation within ninety (90) days from the date of the execution of this contract. Such plant or plants shall be of sufficient size and capacity to treat all the gas of the kind and quality hereinafter described that may be produced by said party of the first part from said premises, and the said party of the second part agrees that such plant or plants shall be of such efficiency as to remove approximately ninety (90) per cent of all of the recoverable gasoline content which such natural gas carries; and further agrees to provide suitable and efficient apparatus for protection against fire and to use only skilled and efficient help to keep the premises in and about the plant in a neat, clean and workmanlike manner; and further agrees to keep the plant in full operation continuously subject only to fires, strikes, acts of God, public enemies and other causes beyond the control of the second party, so long as not less than one million feet of gas per day shall be delivered by the first party to the second party.

(Testimony of Lloyd Aubert.)

Third: The second party further agrees to submit for approval to the first party plans and drawings of said plant previous to the installation thereof.

Fourth: It is understood and agreed that the first party is operating the wells in the Signal Hill District primarily for oil production and may at any time discontinue production on any or all thereof or redrill the same or make any changes in the operation of such wells or any of them, as in its judgment it may deem desirable, regardless of the effect such change may have on the amount or quality of the gas produced; and it is further understood that the first party has not made and does not make any representations whatsoever as to the quantity, quality or pressure of gas.

Fifth: The first party hereby agrees to deliver to the second party at the traps or casing-heads of the wells in said Signal Hill District during the life of this agreement as hereinafter set forth, all gas which is now or which may be hereafter produced by the first party from any or all wells located in said Signal Hill District, and the said second party shall have the right to apply such vacuum if any as the first party shall hereafter indicate, and the vacuum to be applied to such wells may be changed from time to time as conditions in such wells warrant, but such change can only be made upon the sanction and consent in writing of said first party.

Sixth: The second party agrees to pay to the first party for said gas a royalty based upon the

(Testimony of Lloyd Aubert.)

average daily production of gasoline for any calendar month at the rate of thirty-three and one-third (33-1/3%) per cent of the gross amount of the gasoline [79] extracted from the aforesaid gas.

Seventh: The first party hereby reserves the right to take the royalty either in money or gasoline, and further reserves the right to approve any contract the second party may make for the sale of the royalty gasoline in the event the first party elects to accept its royalty in money. An option once exercised to take either in money or in kind shall not be changed for at least six months. In the absence of any written notice, it shall be deemed that the party of the first part elects to take its royalty in money.

Eighth: It is understood and agreed that in the event the first party elects to accept is royalty in money, it is to receive payment on the tenth day of the month for the production of the previous calendar month, and in the event the first party elects to accept its royalty in gasoline the same shall be stored free of charge by the second party for a period of ten days from and after the first day of the month following that in which the gasoline is produced.

Ninth: In this connection it is distinctly understood and agreed that the party of the second part shall not be obligated to make such installation or to treat gas containing four-tenths (4/10) of one gallon of gasoline per thousand cubic feet or less, unless the party of the second part may so elect, and in the event the said party of the second part shall refuse to treat gas containing four-tenths (4/10)

(Testimony of Lloyd Aubert.)

or less of one gallon of gasoline per thousand cubic feet, the party of the first part may sell and dispose of such gas in any manner it may so desire.

Tenth: The second party agrees to deliver to the party of the first part after treatment a minimum of seventy (70%) per cent of the gas collected from the wells and put into the plant for treatment, and further agrees to deliver such gas at a pressure sufficient to enable the first party to deliver said gas to a compressor plant to be erected adjacent to the plant of the second party, such pressure to be not less than ten pounds to the square inch, and in no event shall such pressure exceed one hundred pounds to the square inch unless at the consent of the first party.

Eleventh: It is further agreed that the second party shall have the privilege and option of treating gas in said plant other than that received from the first party, but it is distinctly understood and agreed that in this event orifice meters shall be installed on incoming and outgoing gas to and from the different owners, in order that at all times first party will secure and receive proper credit for the gas produced by it from its wells and received by the second party.

Twelfth: It is further agreed that the first party shall have free access to the plant at all times during business hours and [80] that the books of the second party insofar as they refer to the affairs of the first party shall be open to its inspection.

(Testimony of Lloyd Aubert.)

Thirteenth: The second party agrees to erect such storage tanks upon the property as may be necessary to store the gasoline produced in said plant, and such tanks shall be insulated and of such type and equipment as to prevent an undue amount of evaporation.

Fourteenth: It is further agreed that the first party shall furnish the second party the pro rata quantity of fuel used by the second party in the operation of said plant, and such pro rata quantity of fuel shall be based upon the total volume of gas handled in said plant.

Fifteenth: The second party further agrees to protect and hold harmless the first party on account of any litigation or damages that may arise by reason of method of treatment applied by said second party to said gas, or the design of the plant erected upon said premises, and also agrees to hold first party harmless on account of any accident or injury to any person or persons or any surrounding property that may arise out of the erection or operation or maintenance of said plant, and to pay all County, State and Government taxes that may be levied against said plant or its operation, not including taxes which the first party is required to pay on account of the royalty it receives from the extraction of such gasoline.

Sixteenth: The first party hereby guarantees that it is the owner of and is lawfully entitled to deliver to said second party such gas as is now produced or may hereafter be produced in the said Signal Hill

(Testimony of Lloyd Aubert.)

District, and will hold harmless said second party on account of any litigation that may hereafter arise between the parties hereto and any third party on account of the failure or pretended failure of the first party to deliver such gas to any other person or corporation than the second party hereto.

Seventeenth: In the event said second party shall treat in said plant gas other than that produced by the said party of the first part from said premises herein described, the quantity of gasoline contained in the respective gases so treated in said plant shall be determined by weekly tests of separate gases delivered and treated at said plant.

Eighteenth: This agreement shall continue in force and effect so long as the party of the first part shall have available gas in the said Signal Hill District.

Nineteenth: It is further distinctly understood and agreed that in determining any question or dispute which may arise in the [81] execution of this contract that the same shall be determined by a Board of Arbitrators to be composed of one member appointed by the first party and one member appointed by the second party, and those two persons to appoint a disinterested third person, and the decision of the majority of the Board of Arbitrators shall prevail.

In the event of breach of any of the terms of this contract by the second party, and a continuance of said breach for thirty days after written notice by

(Testimony of Lloyd Aubert.)

the first party to the second party to perform said contract, then at the option of the first party, this contract shall forthwith become null and void and the rights of the second party to receive any further gas from the lands hereinabove described shall cease and determine.

IN WITNESS WHEREOF, the parties hereto have caused this contract to be executed in triplicate by their proper officials, who were thereunto duly authorized.

GENERAL PETROLEUM CORPORATION

(Seal) By (s) R. E. MAYNARD
Vice President

By (s) D. W. WOODS,
Asst. Secretary.

BANKLINE OIL COMPANY

(Seal) By (s) A. L. WEIL
Vice President

By (s) R. C. PETERSON
Sec'y.

Cross-Examination.

I have been General Manager of Bankline Oil Company since 1927. I am familiar with the operation of a company treating gasoline under casinghead gas contracts. I am familiar with the general [82] types of contract used in the field in 1927, 1928 and 1929.

I do not know whether there were two types of contracts in use at that time. I cannot interpret the

(Testimony of Lloyd Aubert.)

contracts which have been submitted in evidence. They speak for themselves. I believe there is one type of contract under which the Bankline Oil Company operates.

(Witness was thereupon referred to preamble of Exhibit 1 and Exhibit 2.)

The two statements mean exactly the same to me.

SCOTT H. DUNHAM,

being first duly sworn, testified on behalf of petitioner as follows:

I reside in Berkeley, California. I am a certified public accountant in charge of tax work for the firm of Haskins and Sells, and have been in that business for five years. As a part of my professional duties I have examined the books of Bankline Oil Company for the years 1927, 1928 and 1930. I have also had a great deal of work on these books done by a crew of ten or twelve different men who were working under my supervision. They compiled information setting forth the gross income derived under each casinghead gas contract, the royalties paid, various statistics relating to the volume of gas coming from each, theoretical content of gasoline, the actual gasoline re- [83] covered, the dry gas recovered under each lease and sold, the royalties paid on the dry gas, and the gross revenue after payment of all royalties. That has been collected in the statement.

(Testimony of Scott H. Dunham.)

Counsel for respondent having objected to the materiality of said statement counsel for petitioner stated:

"Practically all of these contracts provide for a 33-1/3 per cent royalty. We will show, for example, in the several years that the royalty was 40 or 45 per cent. That is the market value of the gas at the well. We paid a 33-1/3 per cent royalty. The case was worth 40 per cent., we will assume, for a given year. The difference between 33-1/3 per cent. and 40 per cent. we will claim under this Board of Tax Appeals decision is the amount on which the depletion shall be taken, and we have got to show what the numbers involved were. We are not asking counsel to concede or admit in any way by the admission of this testimony that we did have a depletable interest in there or that that is the proper method of computing the value of the depletable interest."

Whereupon counsel for respondent said:

"With counsel's statement, there is no objection."

The said statement was then introduced in evidence as petitioner's Exhibit No. 8, as follows: [84]

(Testimony of Scott H. Dunham.)

BANKLINE OIL COMPANY

SUMMARY REFLECTING GROSS INCOME DERIVED FROM ABSORPTION PLANT OPERATIONS, AMOUNTS RECEIVED ON SALES OF ALL PRODUCTS DERIVED FROM THE TAXPAY
IN NATURAL GAS RESERVES ACQUIRED UNDER THE PROVISIONS OF CASINGHEAD GAS CONTRACTS, ROYALTIES PAID THEREON, ETC., FOR THE CALENDAR YEAR

	GASOLINE						DRY GAS								Gross income from gasoline, dry gas, etc.
	Wet gas delivered to plant M cu. ft.	Theoretical gasoline content Gallons	Gasoline recovered Gallons	Less royalties Gallons	Value of gasoline recovered Amount	Less royalties Amount	Plant fuel shrinkage and line loss M cu. ft.	Dry gas available for delivery to lessor or for sale M cu. ft.	Dry gas returned to lessor M cu. ft.	Dry gas available for sale M cu. ft.	Gas blown to air M cu. ft.	Gas sales M cu. ft.	Gas sales Amount	Less royalties Amount	
Bankline account Superior							26,949				146				
General Petroleum Corporation	1,678,337	5,563,455	4,693,962	1,564,656	$468,221.31	$156,073.97	507,163	1,171,174	606,125	565,049	321	564,728	$53,615.23	$26,807.63	$521,836.54
Superior Oil Co.	523,798	1,790,603	1,508,686	502,893	150,191.22	50,063.53	130,950	392,848	154,942	237,906*					150,191.22
Bankline Oil Company	45,940	100,619	80,594	26,866	8,082.15	2,694.17	14,122	31,818	1,129	30,689	7	30,682	3,068.20	1,534.10	11,150.35
Sterling Absorption Plant	1,184		3,115	2,336	404.95	303.68	354	830	545	285		285	27.58		432.59
Total	2,249,259	7,454,677	6,286,357	2,096,751	$626,899.63	$209,135.35	679,538	1,596,670	762,741	833,929	474	595,695	$56,711.01	$28,341.73	$683,610.64

*Indicates M cu. ft. delivered to Midway for Superior.

SUMMARY REFLECTING TOTAL INCOME RECEIVED AND ROYALTIES PAID IN CONNECTION WITH ABSORPTION PLANT OPERATIONS

	Gross income	Less royalties	Income after deducting royalties
Recorded income attributable to and royalties paid under all casinghead gas contracts	$683,610.64	$237,477.08	$446,133.56
Dry gas delivered on order of General Petroleum Corporation	26,885.69	26,807.63	78.06
Total	$656,724.95	$210,669.45	$446,055.50
Wet gas sales—Unlocated	481.63	)	
Royalties—Sterling Absorption Plant—Unlocated	13.79	393.68)	101.74
Remainder	$656,229.53	$210,275.77	$445,953.76
Revenue from gasoline derived from absorber oil	13,672.70		13,672.70
Revenue from dry gas sales not distributed to lessors	16,105.81		16,105.81
Charges to Delano Land Co. for difference between value of dry gas and wet gas supplied	983.43		983.43
Cancellation of charges for transportation costs—1926	570.87		570.87
Excess plant fuel from Superior leases	1,729.70		1,729.70
Total	$685,832.64	$210,275.77	$475,556.87

VED FROM THE TAXPAYER'S INTEREST
R THE CALENDAR YEAR 1927

	Less royalties Amount	Gross income from gasoline, dry gas, etc.	Less royalties paid	Income after deducting royalties
23	$26,807.63	$521,836.54	$182,881.60	$338,954.94
		150,191.22	50,063.53	100,127.69
20	1,534.10	11,150.35	4,228.27	6,922.08
58		432.53	303.68	128.85
31	$28,341.73	$683,610.64	$237,477.08	$446,133.56

ERATIONS

Income after deducting royalties
$446,133.56
78.06
$446,055.50
101.74
$445,953.76
13,672.70
16,105.81
983.43
570.87
1,729.70
$475,556.87

(Testimony of Scott H. Dunham.)

BANKLINE OIL COMPANY

SUMMARY REFLECTING GROSS INCOME DERIVED FROM ABSORPTION PLANT OPERATIONS, AMOUNTS RECEIVED ON SALES OF ALL PRODUCTS DERIVED FROM THE TAX
IN NATURAL GAS RESERVES ACQUIRED UNDER THE PROVISIONS OF CASINGHEAD GAS CONTRACTS, ROYALTIES PAID THEREON, ETC., FOR THE CALENDAR Y

	GASOLINE						DRY GAS							
	Wet gas delivered to plant M cu. ft.	Theoretical gasoline content Gallons	Gasoline recovered Gallons	Less royalties Gallons	Value of gasoline recovered Amount	Less royalties Amount	Plant fuel shrinkage and line loss M cu. ft.	Dry gas available for delivery to lessor or for sale M cu. ft.	Dry gas returned to lessor M cu. ft.	Dry gas available for sale M cu. ft.	Gas blown to air M cu. ft.	Gas sales M cu. ft.	Gas sales Amount	Less royalties Amount
Bankline account Superior							88,915							
General Petroleum Corporation	4,273,185	11,050,487	6,935,409	2,311,803	$590,513.23	$196,837.72	513,742	3,759,443	721,649	3,037,794	1,467,876	1,569,918	$156,991.80	$78,495.90
Superior Oil Co.	847,155	3,046,491	1,925,074	641,687	164,112.08	54,703.68	211,783	635,372	150,026	485,346	85,751	399,595*		
Bankline Oil Company	113,884	273,834	175,773	58,593	15,008.24	5,002.93	18,365	95,519		95,519		95,519	9,551.90	4,665.20
Total	5,234,224	14,370,812	9,036,256	3,012,083	$769,633.55	$256,544.33	654,975	4,490,334	871,675	3,618,659	1,553,627	2,065,032	$166,543.70	$83,161.10

*Delivered to Midway Gas Co. for Superior.

SUMMARY REFLECTING TOTAL INCOME RECEIVED AND ROYALTIES PAID IN CONNECTION WITH ABSORPTION PLANT OPERATIONS

	Gross income	Less royalties	Income after deducting royalties
Recorded income attributable to and royalties paid under all casinghead gas contracts	$936,177.25	$339,705.43	$596,471.82
Dry gas delivered on order of General Petroleum Corporation	78,495.90	78,495.90	
Total	$857,681.35	$261,209.53	$596,471.82
Revenue from gasoline derived from absorber oil	13,535.65		13,535.65
Revenue from dry gas sales not distributed to lessors	13,487.60		13,487.60
Plant fuel and shrinkage adjustment—Superior leases	8,891.50		8,891.50
Total	$893,596.10	$261,209.53	$632,386.57
Correction of 1927 charges to General Petroleum Corporation	12.05		12.05
Remainder	$893,584.05	$261,209.53	$632,374.52

RIVED FROM THE TAXPAYER'S INTEREST
FOR THE CALENDAR YEAR 1928

Gas sales Amount	Less royalties Amount	Gross income from gasoline, dry gas, etc.	Less royalties paid	Income after deducting royalties
$156,991.80	$78,495.90	$747,505.03	$275,333.62	$472,171.41
		164,112.08	54,703.68	109,408.40
9,551.90	4,665.20	24,560.14	9,668.13	14,892.01
$166,543.70	$83,161.10	$936,177.25	$339,705.43	$596,471.82

OPERATIONS

Income after deducting royalties
$596,471.82
$596,471.82
13,535.65
13,487.60
8,891.50
$632,386.57
12.05
$632,374.52

BANKLINE OIL COMPANY

SUMMARY REFLECTING GROSS INCOME DERIVED FROM ABSORPTION PLANT OPERATIONS, AMOUNTS RECEIVED ON SALES OF ALL PRODUCTS DERIVED FROM THE TAXP
IN NATURAL GAS RESERVES ACQUIRED UNDER THE PROVISIONS OF CASINGHEAD GAS CONTRACTS, ROYALTIES PAID THEREON, ETC., FOR THE CALENDAR YE

	GASOLINE						DRY GAS								Gro
	Wet gas delivered to plant M cu. ft.	Theoretical gasoline content Gallons	Gasoline recovered Gallons	Less royalties Gallons	Value of gasoline delivered Amount	Less royalties Amount	Plant fuel Shrinkage and line loss M cu. ft.	Dry gas available for delivery to lessor M cu. ft.	Dry gas returned to lessor M cu. ft.	Dry gas available for sale M cu. ft.	Gas blown to air M cu. ft.	Gas sales M cu. ft.	Gas sales Amount	Less royalties	gas
Bankline—Adjustment account Superior							14,559								
Bankline Oil Company	52,798	142,536	113,815	37,938	$ 8,530.74	$ 2,843.59	11,331	41,467	2,201	39,266		39,266	$ 3,926.60	$ 1,963.30	$ 1
General Petroleum Corporation	2,052,999	5,173,337	4,125,300	1,375,099	309,220.79	103,132.40	438,038	1,614,961	997,818	617,143		617,143	61,714.30	30,857.15	37
Richfield Oil Company	4,101	37,473	29,958	9,986	2,245.86	748,65	902	3,199		3,199		3,199	319.90	159.95	
Superior Oil Co.	448,362	1,179,288	941,852	313,951	70,599.09	23,533.04	91,526	336,836	335,927	909		909			7
Total	2,558,260	6,532,634	5,210,925	1,736,974	$390,596.48	$130,257.68	527,238	1,996,463	1,335,946	660,517		660,517	$65,960.80	$32,980.40	$45

SUMMARY REFLECTING TOTAL INCOME RECEIVED AND ROYALTIES PAID IN CONNECTION WITH ABSORPTION PLANT OPERATIONS

	Gross income	Less royalties	Income after deducting royalties
Recorded income attributable to and royalties paid under all casinghead gas contracts	$456,557.28	$163,238.08	$293,319.20
Dry gas delivered on order of General Petroleum Corporation	30,857.15	30,857.15	
Total	$425,700.13	$132,380.93	$293,319.20
Revenue from gasoline derived from absorber oil	5,440.29		5,440.29
Revenue from dry gas sales not distributed to lessors	1,258.50		1,258.50
Total	$432,398.92	$132,380.93	$300,017.99

ERIVED FROM THE TAXPAYER'S INTEREST
, FOR THE CALENDAR YEAR 1930

Gas sales Amount	Less royalties	Gross income from gasoline, dry gas, etc.	Less royalties paid	Income after deducting royalties
$ 3,926.60	$ 1,963.30	$ 12,457.34	$ 4,806.89	$ 7,650.45
61,714.30	30,857.15	370,935.09	133,989.55	236,945.54
319.90	159.95	2,565.76	908.60	1,657.16
		70,599.09	23,533.04	47,066.05
$65,960.80	$32,980.40	$456,557.28	$163,238.08	$293,319.20

OPERATIONS

	Income after deducting royalties
3	$293,319.20
5	
3	$293,319.20
	5,440.29
	1,258.50
3	$300,017.99

J. LEE CROSS,

being first duly sworn, testified on behalf of petitioner as follows:

I reside in Los Angeles. I am in the business of making contracts for gasoline and leases with land owners. I have been in that business over twenty years, and between the years 1925 to 1932 I have been connected with Signal Oil and Gas Company, California Gasoline Company, Southwestern Gasoline Company, California Gasoline Corporation, California Petroleum Company, The Texas Company, The Signal Company and the Los Angeles Gasoline Company. My duties were to secure gas contracts for these companies. By that I mean contract for the gas produced with the oil at the well. A casinghead company is a gas treating company that lays lines to the producing wells. They take the natural gas at the mouth of the well, carry it through their own pipe lines to their own plant, and extract the gasoline therefrom. During the years in question no wet gas was ever sold at the mouth of the well for cash. The ordinary procedure of purchasing this gas is for the gasoline absorption company to pay a royalty on the gasoline extracted from the gas. During the years 1925 to 1932 I was familiar with the fair market value of casinghead gas at the wells in Signal Hill and Santa Fe Springs oil fields. The markets were practically the same. The amount of royalty paid varied from year to year. In 1922 the prevailing royalty at the well was 33%; in 1926 it was 42½% to 45%; in 1927 it was 45%; in 1928

(Testimony of J. Lee Cross.)

47½%; and in 1930, and since then, about 50%; in 1925 it was 42½%. [88]

Cross-Examination by Mr. Brabson.

We sometimes made gasoline contracts with land owners, but more often with the producer. I also made contracts with the oil lessees. They are the producers. We made some contracts with lessors direct. I was not acting as a real estate agent but as a contract man in these transactions.

The various oil companies I mentioned were practically one company. I have had the same job but have been transferred from company to company. I was on a salary all the time. I did not make any of the contracts in question in this suit.

I don't know whether natural gas is ever sold at the well, but I don't know of any that was ever sold for cash where there were casinghead plants. There is a great variance in the gasoline content of wet gas, which varies from field to field. I don't know that this is the real reason there is no posted price for wet gas. I think the reason is that the contracts are made with the operator prior to the time the wells come in.

It makes no difference whether the gas is rich or lean, whether you have a half gallon or four or five gallons. The royalty rate is just the same.

Ninety to ninety-five percent of the extraction contracts are made before the wells are brought in. The gasoline content varies from half a gallon to five or six gallons per 1000 cubic feet of gas. That means that from some gas the [89] absorption plant

(Testimony of J. Lee Cross.)

can extract half a gallon of gasoline, and from others four or five gallons.

Gas coming from an oil well is not salable to the consuming public as a general rule. The primary reason for casinghead contracts is to extract the gasoline and pay the operator a proportionate amount for the gasoline in the gas. I don't think the operator is primarily interested in getting his wet gas converted to dry gas so he can sell it. Generally speaking his gas is not salable as it comes out.

I would think that public utilities would accept wet gas because if it is wet then they can establish a gasoline plant to extract the gasoline. It is the gasoline in the gas that makes the gas of value. I think that some public utilities do that in Los Angeles, California. They get their gas from various operators, not from our company, as we have our own gasoline plant. I do not know anything about deliveries of gas from the gas companies to the consumers, as I am in the casinghead business. I know about the operation of a casinghead gas plant, and I made contracts similar to those involved in this case.

It is not a fact that there are two general types of contracts. The gasoline company acts the same under all contracts, and assumes all contracts are as one. While firms may have worded them differently, they are operated on exactly the same by all absorption plants. I have worked for pretty nearly half of the absorption plants. I make no distinction in a

(Testimony of J. Lee Cross.)

contract providing for the purchase and sale of gas, and one merely providing for the treatment of it; they are all processing contracts. [90]

The reason the contracts do not provide for a price per unit for the wet gas but a royalty is based upon custom. The varying content of gasoline in the gas is one of the factors why royalty basis is more acceptable than a flat purchase. Another factor is, the gas pressure at the well, whether the company can get it into the lines or has to use compressors.

Q. That would be the same whether it was on a royalty basis or whether it was on a unit basis, would it not?

A. Surely, but it is still a factor in the value of the gas.

Q. If that is the same factor in both cases, how does it make any difference?

A. I do not believe you are making yourself clear.

Q. Well, anyhow, wet gas is never sold on a basis of a unit price, is it?

A. Not to my knowledge.

Generally the contracts provide that after the extraction of the gasoline, the dry gas is returned to the producer.

I have no evidence except my bare statement that royalties paid on contracts vary from 33-1/3% in 1923 to 50% in 1930. I do not know what these contracts provide, and I am not familiar with contracts made by Bankline Oil Company since 1923.

(Testimony of J. Lee Cross.)

While I have not made any contracts for Bankline since 1923, I believe I know the royalties they paid. I have seen lots of contracts where they were attempting to get business in competition with ourselves and other companies, even though I have not seen any of the contracts here in question.

I am familiar with the general type of casinghead gas contracts entered into for extraction of gasoline in which the owner of the casinghead plant goes to an operator and says that he would treat his gas for so much royalty. Only the gas, and not the oil that comes out of the well, is the subject on which these contracts operate. [91]

T. L. TAGGART,

being first duly sworn, testified on behalf of petitioner as follows:

I reside in Los Angeles County, and am contract superintendent of the Standard Gasoline Company. I have had that job since 1926, when that company was formed. I was also in the natural gasoline business before that time.

The Standard Gasoline Company is the biggest casinghead gasoline company in the state. My duties with that company are to make gas processing contracts. The natural gas is sold on a royalty basis, and is not sold for cash.

I know the going rate of royalty on casinghead contracts between 1925 and 1932 in Santa Fe Springs

(Testimony of T. L. Taggart.)

and Signal Hill oil fields. It was the same in both places and varying from year to year. In 1925 the going rate was 35%; in 1926 41%; in 1927 it averaged about 43%; in 1928 it was 45%; in 1929 about the same; in 1930 about 47%; and since that time it has gradually increased to 50%.

Cross-Examination by Mr. Brabson.

I have never made any contracts with Bankline Oil Company and am not familiar with any of their contracts.

Witness then shown petitioner's Exhibit No. 1, dated October 9, 1928, and on examination states that he sees a clause in which Bankline agrees to pay the producer 33-1/3% of the gross [92] proceeds derived from the sale of gasoline extracted from wet gas taken from the property covered by the contract. Counsel for petitioner then admitted that was the only royalty.

Witness was handed petitioner's Exhibit No. 2, dated October 25, 1923, and stated that this provides for 33-1/3% royalty.

Witness was then handed petitioner's Exhibit No. 7 dated October 9, 1928, and stated that royalty is 33-1/3%.

I made gas processing contracts during 1927, 1928 and 1930 for the Standard Gasoline Company in the same field. I did not make any 33-1/3% contracts during those years. I cannot deny that there were not some contracts that were entered into on the 33-1/3% basis during those years. I just testified

(Testimony of T. L. Taggart.)

we did not make any at that rate. All the contracts made by Standard Gasoline Company passed through my office. I make no distinction between a gas treatment contract and a contract for purchase and sale.

JOHN McFARLAND,

being first duly sworn, testified on behalf of petitioner as follows:

I reside in Glendale, California. I am in the natural gas business in charge of the Contract Department of Gilmore Oil Company, Gilmore Dabney, and Gilmore Plant No. 1. I have been in that business since the beginning of 1924, and know the going rates of royalty paid on casinghead gasoline contracts in Santa [93] Fe Springs and Signal Hill fields for the years 1926 to 1930. They were the same in both fields, but varied from year to year. In 1925 the going rate was 37½%; in 1926 40%; in 1927 45%; in 1928 to 1932, inclusive, 50%; in 1933 52½%.

Petitioner thereupon rested.

F. K. BAXTER,

being first duly sworn, testified on behalf of respondent as follows:

I reside in Pasadena, and am engineer revenue agent with the Internal Revenue Bureau. I entered

(Testimony of F. K. Baxter.)

the employ of the Federal Government in 1922 as a valuation engineer, and I came to California in 1925. I became an engineer revenue agent, the duties being unchanged. I graduated from the Massachusetts Institute of Technology in 1901, taking a course in mining engineering and metallurgy, which also included oil and gas. I followed mining until about 1908 when I entered the employ of the Associated Oil Company in the Geological Department. After two years with them I went into private practice as a mining and petroleum engineer in California. I remained a consulting engineer for about two years, and in 1913 entered the employ of the Shell Company. I worked for seven years with them as an engineer in their Geological Department. My duties with those companies were mapping oil fields and obtaining information relative to oil wells and their conditions. I never had anything to do with a casinghead gasoline plant, although I submitted a design for one of the first ones, which was utilized in part. [94]

I left the employ of the Shell Company and went back into private practice. I was then employed by the Amalgamated Oil Company for about two years, until July, 1922, when I entered the employ of the Federal Government.

Since then my job has been the valuation of oil and gas produced, for the purpose of determining depletion and gain or loss on sale of capital assets and determination of reserves for both oil and gas.

I am familiar with the question of amortization

(Testimony of F. K. Baxter.)

for casinghead contracts for income tax purposes. It became a problem of considerable importance about 1923, at which time I made a study of the subject. I have been engaged in that study ever since.

The question of allowance of percentage depletion for wet gas first came up for consideration for income tax purposes about 1926. There has never been any provision in the regulations allowing for depletion of that sort. In stating that, I had in mind particularly the amortization of casinghead contracts. I know the law never provided for any such return to be considered as depletion. The regulations specified that casinghead gas contracts, being considered capital assets, might be returned by adding their cost to the capital sum returnable through depletion. However, when the percentage depletion allowance came into effect as of January 1, 1925, the corresponding regulations were silent as to any amortization for casinghead [95] gasoline contracts, and all regulations since have been silent on that subject. A casinghead gas contractor could have no depletory sum prior to the time he got the contract. He would have no capital sum to which to add the cost of casinghead gas contracts. The nature of the depletory interest from an engineering standpoint is an interest of an operating owner who owns the fee or we may say the mineral estate, the same operating owner becoming a lessee under that lessor, a sublessee under a sublessor, or the assignees of any of the aforementioned. And we have now come to

(Testimony of F. K. Baxter.)

the point where anyone owning any of the previously mentioned interests assign such interest, retaining a right to receive income therefrom as distinguished from a mere right to receive income acquired by direct purchase, and not predicated on any prior interest in the particular property.

Gas is the personal property of the operator after reduced to possession. I term that a depletory interest.

As engineering revenue agent I have examined numerous casinghead contracts.

Witness was then shown Exhibits 1 and 2.

By contractor I mean the operator of the casinghead plant.

The natural gas is taken at the well or at the gas trap and conveyed to the treatment plant where the pressure is raised or lowered, as necessary. The gas is brought in contact with absorption oil and the gasoline is absorbed by the oil. The oil is afterwards retorted and the casinghead gasoline separated from the oil. That process involved considerable machinery and equip- [96] ment, and requires a considerable outlay for a plant.

Going into a more detailed description, the gas first goes through a scrubber, which is supposed to take out any oil that might be conveyed, after which the pressure is properly adjusted to the plant, usually about 42 in many plants above atmosphere, and there are cooling processes, and finally the gas finds its way to the absorption tower, where it is brought in close contact with the oil. There are dif-

(Testimony of F. K. Baxter.)

ferent partitions in the absorption tower so as to make the best contact possible and permit the oil, which has a gravity ordinarily varying from 29 to 35 degrees—that oil is supposed to be devoid of these same hydrocarbons which are represented by the gasoline vapors and therefore, has an affinity or power of absorbing these particular carbons, and when the process is continued for a sufficient time that absorption oil, as I said before, is retorted and the gasoline fraction removed.

The gasoline is further treated to eliminate the so-called wild product, after which it is sold for blending purposes or for other purposes, and the dry gas is then raised to the necessary line pressure to enter the lines of the purchaser. As a rule it goes to a public utility. To whom the casinghead man returns it depends upon each particular contract. Exhibits 1 and 2 do not vary as to their method of treatment of gas.

I am familiar with the types of casinghead contracts used by the various operators. There are several types of those contracts. When I say type, I mean changes in wording. There is [97] one type which says that the producer agrees to sell and the casinghead man agreed to buy. The other merely provides for the treatment of gas. In some cases it is provided that all the dry gas, except that required for gasoline plants, should be returned to the producer, and he can either market it himself or burn it on his own property, or blow it into the air, or use it for repressure. Sometimes the gas is recirculated

(Testimony of F. K. Baxter.)

back through the formation to absorb more gasoline. That gasoline is either sucked out of the well under vacuum, or if the pressure is great enough will issue from the well under its own pressure. It is then returned to the plant. Under those circumstances it merely acts as a mechanical conveyor of gasoline. Some gas treated in the plant is represented by true natural gas, but the larger element is composed of gas that has been through the plant before and has completed its circulation. Many times the gas which is forced back into the formation does tend to increase the production of oil, and that oil is usually of lower gravity because of the absorption of the lighter hydrocarbons. In other words, a large amount of gas goes through the absorption plant several times.

The treatment of casinghead gas is primarily for the purpose of separating an unsalable product—unsalable in the sense that public utilities would not accept it. It is salable only to one who has a casinghead plant, or knew of a casinghead plant to which he could dispose of his gas. Wet gas is usually unsalable and must be treated. There are two products from wet gas—gasoline [98] and dry gas, both of which are salable. In the early days wet gas was used primarily for boiler fuel or lease fuel. Before gas is valuable for domestic use, the gasoline must be extracted. In some of the contracts with which I am familiar, the dry gas belongs to the casinghead contractor, while in other cases it belongs to the producer, and is sold under his instructions. The

(Testimony of F. K. Baxter.)

casinghead man sells it for his account and accounts to him.

There is no price per unit for wet gas in California for the reason that no one knows what the wet content of the gas will be. Different wells on the same lease show a different gas content at the same time, and the same well over its life will yield wet gas that varies in gasoline content. As the pressure lowers, the gasoline content increases, but the volume of gas decreases. Wet gas is never sold on a basis of a unit price in California, but is sold under a gas treatment contract in which the contractor agrees to pay a certain percentage of the gasoline, retaining a certain part of the dry gas for use in the plant, and returning all or a portion of the dry gas to the producer. In some cases the operator of the well sells the gasoline to the casinghead man for a price contingent on the yield of the gas. There are some contracts in which the casinghead gas contractor furnishes his services as an extractor and turns the dry gas back to the owner. That is the class I have called the gas treatment contract. In my experience I found [99] two broad types of contract—the gas treatment and the purchase and sale contract. The casinghead man accounts to the operator of the well for the dry gas sold. The dry gas is no more a by-product of gas operations than is gasoline. The public utilities purchasing dry gas require it to be just as dry as possible. Whether the dry gas or the gasoline is a more valuable part of the wet gas depends entirely on the gasoline content

(Testimony of F. K. Baxter.)

of the natural gas. I know of certain cases where the lessor was required to pay not only all of his share of the gasoline produced but a portion of his share of the income from the dry gas produced in order to have his wet gas processed. That situation arose from an agreement whereby the lessor agreed to stand his pro-rata share of the treatment process, and that prorata share was in excess of the lessor's share of the gasoline sold and extracted. The gasoline must be extracted from wet gas to make the gas marketable and also to make the gasoline salable.

I have examined a number of gas contracts, and from that examination I have seen contracts providing for higher rate of royalty than that provided for in petitioner's Exhibits 1 and 2. I have also seen numerous contracts providing for a rate of 33-1/3%. or less.

There is no question but the royalty rate increased from 1923 to 1928. In 1923 there were more at 33-1/3% than there were at less than 33-1/3%. That was the usual rate in 1923—33-1/3%. Gradually the rate has increased, as has been testified to here, and up to 37½ and 40 to 45 and up to 50. I have found [100] numerous contracts at 33-1/3% in the years 1926 to 1928. I could not attempt to say what companies they were.

The first gas extractor plants in California were erected by the oil operators for the purpose of treating their own products. That continued until the flush fields came in in 1921, 1922 and 1923. Then independent operators who secured their gas from

(Testimony of F. K. Baxter.)

the producers by contract began to build plants for the treatment of the gas. Wet gas is always produced in conjunction with oil in California.

It was stipulated by and between petitioner and respondent that casinghead companies under contract providing for a 33-1/3% royalty keeps 2/3 of the gasoline and 1/3 of the gasoline is returned to the producer of the oil and he divides it with his lessor in accordance with their lease contract.

(The Witness): It is usually provided that a substantial part of the dry gas, between 66-2/3 and 75%, remains the property of the producer. The gas does not strictly remain the property of the producer, because the gas when used is commingled with gas from many different properties. A casinghead company may have a contract with fifty different producers from which it secures wet gas which is commingled in the plant. They then make a test to determine what each producer's proportion of the commingled amount it, and when the producer gets his gas or gasoline back, it is not necessarily the gas or gasoline that came from his property, but is a percentage of the commingled [101] wet gas. That, of course, is not true where a plant merely takes the gas from one operator. In that event the dry gas remaining after treatment is returned to that operator, or is sold either by the casinghead plant to a public utility as agent for the operator. The utilities as a rule pay the casinghead plant, and the casinghead plant settles with the producer. The gasoline produced very often goes to a refiner. He pays the

(Testimony of F. K. Baxter.)

casinghead operator usually, but sometimes it is provided in the contract that the producer's share shall be paid directly to him.

The pipe lines of a casinghead plant are connected directly with the well or a gas trap. That is a device to separate oil that is carried along with the gas. In recirculating operations dry gas from casinghead plants is introduced into intake wells under pressure for two purposes—to increase the production of the oil and to absorb gasoline vapors from the gas. This is done in fields in which the rock pressure or natural pressure has gone down. That is a substantial part of the cost of operating an absorption plant. They often put the pressure on the gas for injection purposes, although the producer, with the consent of the lessor, puts it into the wells. Some of this gas is used over and over again in the case where the gas is drawn from one source. Of course there is no means of identifying that.

The casinghead contractor, on receiving delivery of [102] wet gas, takes it to his plant to separate the gasoline from the dry gas. He thereafter sells the gasoline and sometimes the dry gas as well. He sometimes is required to repressure the property, that is, with his compressors he must raise the gas to the required pressure for injecting it. Sometimes gas from other fields is injected. The component parts into which wet gas is separated are generally gasoline and dry gas, and sometimes butane and lamp black. The usual contract deals with nothing

(Testimony of F. K. Baxter.)

but the gas and gasoline. After the rock pressure has subsided, wells are pumped under vacuum. When the production of natural gasses decreases they have to inject gas or there would not be enough for treatment in the gas plant.

By foreign gas I mean gas from other fields or in other properties. Gas which has been injected for repressuring purposes is a natural gas but not a natural product. It is merely a mechanical device to force the oil towards the well and for the absorption of gasoline vapors.

Cross-Examination

By Mr. WEIL:

If a casinghead plant is being supplied by three different properties, the gas from those three properties is not kept separated as it goes through the plant, but it is all commingled. The gasoline content per thousand cubic feet of gas at Signal Hill and Santa Fe Springs varies about half a gallon up to two and a half or three gallons at the present time. There is [103] probably not any property in Santa Fe Springs producing as low as half a gallon right now. I can't name any property in either field producing less than a gallon and a half of gasoline per thousand cubic feet of gas at the present time.

In 1930 the price of casinghead gasoline averaged from 7¢ to 10¢ per gallon. So there would be from 10¢ to 15¢ worth of gasoline in a thousand cubic feet of gas, figuring on the basis of a gallon

(Testimony of F. K. Baxter.)

and a half per thousand cubic feet. In 1930 the public utilities were paying 10¢ per thousand cubic feet for gas under contracts they had entered into prior to 1930. I don't know what they would have paid in 1930. If a thousand feet of gas were produced from a well in 1930, and it went to a casing-head gasoline plant which had the right to sell both the dry gas and the gasoline, not under contract but on spot delivery, there is no doubt but that he would receive more money for the gasoline. In 1927 a very substantial quantity of dry gas was blown into the air. I don't know whether or not a larger amount was blown into the air or utilized, but I know a tremendous amount was blown into the air and wasn't used at all.

If a well is flowing under natural rock pressure they do not inject dry gas. Dry gas is used in two ways in the production of oil. One is by gas lift, where the dry gas is injected into the well that is being produced and is allowed to go out below the surface of the liquid in the well. In this case the bubbles thereby caused help the production. When gas is circulated it is [104] injected into so-called intake wells which are not producing at the same time. In that case the gas going into the formation will, it is hoped, produce oil and absorb gasoline vapors from the oil formation. In other words, it is put into the well itself in order to bring the oil out of that well, or it is put into the formation elsewhere to push the oil out through some other well. I do not know of any well where they ever put in gas

(Testimony of F. K. Baxter.)

for the mere purpose of absorbing the gasoline. Their purpose was to increase the production of oil, but the results were that the principal benefit was derived from the absorption of gasoline from the formation by the dry gas.

The casinghead plant operator is interested in getting gas from the formation so that he may secure the wet gas issuing from the well. I think some oil operators try to increase the amount of gasoline because I know of cases where the lessor has put a stop to the practice on the ground that he was not getting his full share. Gasoline taken by the gas injected is not necessarily taken out of the oil. There might be some gasoline vapors in the interstices that would come out with the oil if no gas were interjected, but only very slowly.

Redirect Examination

I do not recall how much gasoline was being wasted in 1927 to recover dry gas. I know it was a comparatively small amount that would get into the dry gas lines. I know of contracts where a lessor made a contract with his lessee to treat [105] the lessee's gas in the lessee's plant on the understanding that the lessor would get a percentage of the gasoline subject to a prorata share and cost of operation, and the cost of operating was raised to such an extent that the lessor was paid not only his share of the gasoline recovered, but a good portion of his income from the dry gas. The production other than gasoline and dry gas had a substantial

(Testimony of F. K. Baxter.)

value. The money realized from butane and lamp black was not a material portion of the income received in 1927.

In determining the comparative values of gasoline and dry gas produced, we must take into consideration that in recent years the state has compelled curtailment under the Natural Gas Waste Law. That was in the last five years. The comparative value of the two products depends upon the gasoline content of the gas. If the gasoline content was small, the value of the dry gas would be greater if there were a market for it. But in many fields they had to waste a great deal of it. For example, in Ventura, even though they had some pretty heavy contracts with utilities, a vast amount of gas was blown into the air. California was producing more natural gas than they knew what to do with.

Respondent thereupon rested. [106]

The foregoing evidence is all of the material evidence adduced at the hearing before the Board of Tax Appeals, and the same is approved by the undersigned as attorney for petitioner.

A. L. WEIL
MARTIN J. WEIL
Attorneys for Petitioner on Review.

The foregoing evidence is all of the material evidence adduced at the hearing before the Board of

Tax Appeals, and the same is approved by the undersigned as attorney for respondent.

HERMAN OLIPHANT
Attorney for Respondent on Review.

This statement of evidence is duly approved and ordered filed this 21st day of July, 1936.

LOGAN MORRIS
Member
United States Board of Tax Appeals

[Endorsed]: Filed July 21, 1936. [107]

[Title of Court and Cause.]

PRAECIPE FOR RECORD

To the Clerk of the United States Board of Tax Appeals:

You will please prepare, transmit and deliver to the Clerk of the United States Circuit Court of Appeals for the Ninth Circuit, copies duly certified as correct of the following documents and records in the above-entitled causes in connection with the petition for review by the said Circuit Court of Appeals for the Ninth Circuit, heretofore filed by Bankline Oil Company, your petitioner.

1. Docket entries of the proceedings before the Board in each of the above docket numbers.

2. Pleadings before the Board in each of the above docket numbers:

(a) Petition, including annexed copy of deficiency letter and all exhibits attached to petition.

(b) Answer.

(c) Amended petition, (including annexed copy of deficiency letter and exhibits attached thereto; duplication is not included).

(d) Answer to amended petition.

3. Order granting motion to file amended petitions.

4. Findings of fact, opinion and decision of the Board.

5. Petition for review, together with proof of service of notice of filing petition for review and of service of a copy of petition for review.

6. Statement of the evidence as settled and allowed.

7. This praecipe.

A. L. WEIL
MARTIN J. WEIL
Attorneys for Petitioner.

Service of a copy of the within praecipe is hereby admitted this 23rd day of June, 1936.

HERMAN OLIPHANT
Attorney for Respondent.

[Endorsed]: Filed June 23, 1936. [109]

[Title of Court and Cause.]

CERTIFICATE

I, B. D. Gamble, clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages, 1 to 109, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 28th day of July, 1936.

[Seal] B. D. GAMBLE
Clerk,
United States Board of Tax Appeals.

[Endorsed]: No. 8294. United States Circuit Court of Appeals for the Ninth Circuit. Bankline Oil Co., a corporation, Petitioner, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Upon Petition to Review an Order of the United States Board of Tax Appeals.

Filed August 3, 1936.

PAUL P. O'BRIEN,
Clerk of the United States Circuit Court of Appeals for the Ninth Circuit.

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14010—37

In the Supreme Court of the United States

OCTOBER TERM, 1937

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

BANKLINE OIL COMPANY, A CORPORATION

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

The Solicitor General, on behalf of Guy T. Helvering, Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Ninth Circuit entered in the above cause on June 7, 1937, reversing the decision of the United States Board of Tax Appeals.

OPINIONS BELOW

The opinion of the Circuit Court of Appeals (R. 145) is not yet officially reported. The opinion of the Board of Tax Appeals (R. 42–56) is reported at 33 B. T. A. 910.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered June 7, 1937 (R. 154). The juris-

diction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer, a casinghead gasoline manufacturer engaged in the processing of wet gas into gasoline and dry gas, obtains its supply of wet gas by contract with oil producers. Is the taxpayer entitled to an allowance for depletion of gas in place because the contract price which it paid for wet gas is below the market price at the time of delivery of the wet gas to the taxpayer by the producers?

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved will be found in the Appendix, *infra,* pp. 10–14.

STATEMENT

The facts as found by the Board of Tax Appeals (R. 43–45) may be summarized as follows:

The taxpayer, a corporation, maintained and operated during each of the taxable years 1927, 1928, and 1930, a casinghead gasoline plant situated in the Signal Hill Oil Field, of Los Angeles, California. In this plant, taxpayer processed raw natural gas, called wet gas, which is not a salable commodity, to secure the two salable commodities gasoline and dry gas. Taxpayer's supply of wet gas was obtained from oil producers under con-

tracts, entered into prior to the taxable years, providing that the taxpayer should install and maintain necessary pipe lines and connections from casingheads or traps at the mouth of the well to its plant, through which to carry the wet gas which the producer delivered. The taxpayer agreed to pay the producer 33⅓ percent of the total gross proceeds derived from the sale of gasoline, or at the producer's option to deliver 33⅓ percent of the extracted gasoline.

Under the contracts (R. 76–115) the taxpayer took no part in the production of the wet gas, conducted no drilling operations upon any of the producing premises, did not pump oil or gas from the wells, and had no interest as lessor or lessee, or as sublessor or sublessee, in any of the producing wells.

The Commissioner determined deficiencies against the taxpayer upon other issues than the depletion issue here involved. By amended petitions (R. 19–25, 35–40) the taxpayer urged that in computing its taxable net income it was entitled to deduct from gross income percentage depletion, in the amount of 27½ percent of gross income, provided such amount did not exceed 50 percent of the net income which it realized under its casinghead gas contracts. The record does not show the net income (computed without allowance for depletion) which petitioner realized under its wet gas treatment contracts.

The Board of Tax Appeals held (R. 47–56) that the interest of the taxpayer under its casinghead gasoline contracts was not in the nature of a profit a prendre; that the contracts gave the taxpayer no interest in the gas in place but only a right to delivery of wet gas after its production and reduction to ownership by others; and that in consequence the taxpayer had wholly failed to establish depletable interest under the statute. The Board held further, however, that if, as a matter of law, a casinghead gasoline plant operator may in some instances have a depletable interest under gas treatment contracts, the taxpayer had failed to show that the value of wet gas at the mouth of the well purchased under its casinghead gasoline contracts was in excess of the amount paid therefor, and in consequence had not shown any proper basis for deductions or the amount of the deductions to be taken in the taxable years.

The Circuit Court of Appeals held that the taxpayer as a casinghead gasoline plant operator had *under its contracts* an economic interest in the wet gas in place which would entitle it to a depletion allowance *provided* the fair market value of wet gas at the casinghead or gas trap exceeded the contract price which taxpayer paid for such wet gas. So holding, and because the record did not show the taxpayer's net income (computed without allowance for depletion) from "the property", the Circuit Court of Appeals reversed the decision be-

low and remanded the case to the Board of Tax Appeals with instructions to allow additional evidence and to fix the depletion allowance in accordance therewith. The Board had held that the wet gas as it flows from the earth is not a salable commodity (R. 44), and the concurring opinion in the Circuit Court of Appeals expressed the view that such a commodity could not have a market value.

SPECIFICATION OF ERRORS TO BE URGED

The court below erred:

1. In holding that the nature of the taxpayer's contracts for a supply of wet gas was such that the taxpayer was entitled to an allowance for depletion, provided it paid less for wet gas under its gas treatment contracts than the market value of such wet gas as established by the current contract price generally being paid in that field under similar contracts entered into during the taxable years.

2. In failing to hold that the taxpayer had no interest in the wet gas in place in the earth which could be the subject of a deduction for depletion.

3. In reversing the decision of the Board of Tax Appeals.

REASONS FOR GRANTING THE WRIT

1. In the present case, the Circuit Court of Appeals for the Ninth Circuit has established the rule for its jurisdiction that casinghead gasoline manufacturers are entitled to an allowance for depletion

if the price which they pay for wet gas to the producer thereof is less than the fair market value of the wet gas at the gas trap or casinghead at the time the wet gas is delivered. In so holding, the Circuit Court of Appeals stated that the right to depletion depends upon an economic interest in the oil or gas in place, and purported to rely upon *Palmer* v. *Bender*, 287 U. S. 551.[1] But the court's conception of an economic interest in the oil or gas in place as presented in this case, and further illustrated by its decision in *Commissioner* v.

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[1] In addition the court below relied upon its own decision in *Signal Gasoline Corp.* v. *Commissioner*, 66 F. (2d) 886, which was also based upon *Palmer* v. *Bender*. Whatever may be the validity of the *Signal Gasoline Corp.* decision, it is clearly distinguishable. There, unlike the present case, the casinghead gas manufacturer had paid a substantial consideration for its gas contracts; had taken direct means to induce a larger flow of oil and gas; had extracted wet gas from the wells by various means; and had assisted in drilling wells by furnishing equipment. Concerning the contracts in that case, the court said (p. 889) that they imposed upon the Signal Gasoline Corporation "the obligation to * * * exert forces which would bring the oil and gas up out of the ground." As a result, the court reached the conclusion in the *Signal Gas* case (p. 889), which it could not possibly reach here, that the oil producer and the casinghead gas processor "were both engaged in continuous steps to win oil and casinghead gas from their position in the earth."

The second decision in the *Signal Gas* case, 77 F. (2d) 728, certiorari denied, 296 U. S. 657, involved merely the method of calculation of the depletion allowance.

O'Donnell,[2] is in probable conflict with *Palmer* v. *Bender, supra,* and with *Thomas* v. *Perkins,* No. 824, October Term, 1936, decided June 1, 1937. The holding below is also in conflict with the decision of the late Judge McDermott, of the Tenth Circuit, sitting as a district judge, in *Hurley* v. *United States,* 10 F. Supp. 365 (N. D. Okla.).

The *Palmer* and *Perkins* cases require that a taxpayer claiming depletion must own some interest in the mineral in place. Here the taxpayer was operating a plant to extract gasoline from gas, and was not engaged in operating a gas or oil well. Under its contracts, taxpayer's earliest possible interest in wet gas was upon delivery by the producer to the trap or casinghead. Each of the contracts specifically provided that the oil producer was the owner of the wet gas produced from the oil properties described (R. 76–77), or was drawn in terms of purchase of the wet gas by the taxpayer and sale by the oil producer (R. 90, 99, 107, 108). Taxpayer was under no obligation to engage in the production of wet gas from the ground, nor could it require such production. Taxpayer's only interest in the wet gas reserves was the same as that of an oil refinery—if its supply of wet gas ran out, it would have to seek other sources for that raw material for its plant. Nor can it in any sense be said in this case that taxpayer secured "by any form of legal relationship, income derived from the

[2] Decided June 14, 1937. The case is not yet reported but may be found in 1937 C. C. H. par. 9362. The Government will file a petition for certiorari in the O'Donnell case.

extraction of the oil, to which he must look for a return of his capital." See *Palmer* v. *Bender*, *supra*, at p. 557. Taxpayer's capital was invested in its processing plant, and its income was not derived from extraction of the oil or gas from the ground, but from the processing of wet gas previously extracted from the ground by independent producers. Moreover, since it is the mineral deposit which is depleted by production, the taxpayer whose interest is confined to the extracted mineral is not within the class of "mines, oil and gas wells, other natural deposits, and timber" to which Section 23 (l) of the statute, *infra*, p. 11, alone applies.

2. An authoritative decision by this Court on the question presented is of great importance to the orderly allowance and proper apportionment of depletion. The question can arise in any jurisdiction where similar casinghead gas production takes place, but appears to be most pressing in the Ninth Circuit. *Norwalk* v. *Commissioner*, now pending before the Ninth Circuit Court of Appeals (No. 8468), presents the same question, and several other cases which will eventually reach the Ninth Circuit Court of Appeals are in earlier stages of litigation.

Furthermore, if the present decision is allowed to stand, the Commissioner must allocate the allowance for depletion between the producer (including all those interested with the producer in and

under the lease; i. e., the lessor and holders of various interests under the lease) on the one hand, and the casinghead gasoline manufacturer on the other. Reduction of the depletion allowance allocable to producer interests will doubtless result in litigation by those interests and probable conflicts of decision. The Bureau of Internal Revenue advises that within the last three years the Commissioner has rejected claims for depletion allowances advanced by approximately 50 casinghead gasoline manufacturers. In addition there are at least 150 casinghead gasoline manufacturers who have not claimed depletion allowances for past years but may still do so. A decision by this Court in the present case will avoid a situation whereby doubtful allowances must be made by the Commissioner to one group and corresponding disallowances to another. Such a condition cannot fail to be productive of further litigation and to be unsatisfactory to the Government and taxpayer alike.

CONCLUSION

Wherefore, it is respectfully submitted that this petition for a writ of certiorari should be granted.

STANLEY REED,
Solicitor General.

SEPTEMBER 1937.

APPENDIX

Revenue Act of 1926, c. 27, 44 Stat. 9, 16, 41:

SEC. 204. (c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—

* * * * *

(2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

SEC. 234. (a) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

* * * * *

(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed

by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee; * * *.

Revenue Act of 1928, c. 852, 45 Stat. 791, 799, 821:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(l) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction shall be equitably apportioned between the lessor and lessee. * * * (For percentage depletion in case of oil and gas wells, see section 114 (b) (3).)

(m) *Basis for depreciation and depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in section 113 for the purpose of determining the gain or loss upon the sale or other disposition of such property, as is provided in paragraphs (2) and (3) of this subsection.

(b) *Basis for Depletion.*—

* * * * *

(3) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

* * * * *

Treasury Regulation 69, promulgated under the Revenue Act of 1926:

ART. 201. *Depletion of mines, oil and gas wells; depreciation of improvements.*—Sections 214 (a) (9) and 234 (a) (8) provide that taxpayers shall be allowed as a deduction in computing net income in the case of natural deposits a reasonable allowance for depletion of mineral and for depreciation of improvements. See section 204 (c) and articles 1602 and 221 with reference to the basis for computing depreciation and depletion.

The essence of these provisions of the statute is that the owner of mineral deposits, whether freehold or leasehold, shall, within the limitations prescribed, secure through an aggregate of annual depletion and depreciation deductions the return of either the cost of his property, or the value of his property on the basic date plus, in either

case, subsequent allowable capital additions (see articles 222 and 223), but not including land values for purposes other than the extraction of minerals. (But see section 204 (c) (2) and article 221.)

Operating owners, lessors, and lessees, whether corporations or individuals, are entitled to deduct an allowance for depletion and depreciation, but a shareholder in a mining or oil or gas corporation is not allowed such deductions. (But see article 1546.)

* * * * *

ART. 1602. *Basis for allowance of depletion and depreciation.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence will be allowed in respect of any property is the same as is provided in section 204 (a) and (b) for the purpose of determining the gain or loss from the sale or other disposition of such property, except that:

* * * * *

(2) With respect to oil and gas wells, the allowance for depletion shall be 27½ per cent of the gross income from the property during the taxable year, but such allowance shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. In no case shall the deduction for depletion with respect to oil and gas wells be less than it would be if computed without reference to section 204 (c) (2) and this paragraph.

See articles 201–237 for the methods of computing allowances for depletion, and articles 161–170 with reference to the allowance for depreciation.

Treasury Regulations 74 promulgated under the Revenue Act of 1928: The applicable Articles of these Regulations are substantially similar to the corresponding Articles in Regulations 69, *supra*, and are not copied here (Cf. Articles 221, 611, Treasury Regulations 74).

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In the Supreme Court of the United States

OCTOBER TERM, 1937

No. 387

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

BANKLINE OIL COMPANY, A CORPORATION

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 42–56) is reported in 33 B. T. A. 910. The opinion of the Circuit Court of Appeals is reported in 90 F. (2d) 899.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered June 7, 1937 (R. 154). Petition for certiorari was filed September 7, 1937, and was granted October 25, 1937. The jurisdiction of this

Court is conferred by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer, a casinghead gasoline manufacturer engaged in the processing of wet gas into gasoline and dry gas, obtains its supply of wet gas by contract with oil producers. Is the taxpayer entitled to an allowance for depletion of gas in place because the contract price which it paid for wet gas is below the market price at the time of delivery of the wet gas to the taxpayer by the producer?

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved will be found in the Appendix, *infra*, pp. 20–23.

STATEMENT

The facts as found by the Board of Tax Appeals (R. 43–45), pertinent to the above question, may be summarized as follows:

The taxpayer, a corporation, maintained and operated during each of the taxable years 1927, 1928, and 1930, a casing-head gasoline plant situated in the Signal Hill Oil Field, Los Angeles, California. In this plant, taxpayer processed raw natural gas, known as "wet gas," into gasoline and dry gas. (R. 43–44.)

Natural gas, commonly known as "wet gas" as it flows from the earth is not a saleable commodity.

It is only through processing—by separation of the gasoline therefrom—rendering it dry, that it may be sold for commercial uses. Conversely, it is only through the separation of dry gas from wet gas that the gasoline is saleable. The content of gasoline in wet gas varies from one-half gallon to six gallons per thousand cubic feet of gas produced, depending upon its richness. (R. 44.)

In and prior to the taxable years the petitioner entered into numerous contracts[1] with oil producers for the treatment of "wet gas" by the extraction of gasoline therefrom. The contracts provided, generally, that respondent should install and maintain the necessary pipe lines and connections from casingheads or traps at the mouth of the well to its plants, through which the producer agreed to deliver to the respondent's plant the natural gas produced at such well. (R. 44.) Respondent agreed to extract the gasoline and to pay the producer one-third of the total gross proceeds derived from the sale thereof, or at the option of the producer, one-third of the saleable gasoline so extracted. A slightly different type of such contract provided for the outright "purchase" from the producer of all natural gas produced, respondent paying one-third of the gross proceeds received by it from the sale of gasoline extracted from such gas. When dry gas was sold respondent

[1] Entirely distinct from the leases of state lands involved in No. 388 under taxpayer's cross petition for certiorari.

accounted to the producer for a proportion of the proceeds. (R. 45.)

Under the contracts (R. 76–115) taxpayer took no part in the production of the wet gas, conducted no drilling operations upon any of the producing premises, did not pump oil or gas from the wells, and had no interest as lessor or lessee, or as sublessor or sublessee in any of the producing wells.

The Commissioner determined deficiencies against the taxpayer upon other issues, and by amended petitions (R. 19–25, 35–40), the taxpayer urged that in computing its taxable net income it was entitled to deduct from its gross income, as percentage depletion, 27½ per cent of the difference between the price paid for the wet gas and its fair market value at the mouths of the wells.

The Board of Tax Appeals held that under the contracts the taxpayer acquired no depletable interest. It further held that the taxpayer had failed to show that the value of wet gas purchased was in excess of the amount paid therefor, and therefore upon its own theory it had not shown any proper basis for deduction.

The Circuit Court of Appeals held that the taxpayer had under its casinghead contracts acquired an economic interest in the wet gas in place which would entitle it to depletion, provided the fair market value of the wet gas at casinghead or gas trap exceeded the price which taxpayer paid for such wet gas. So holding, and because no finding had been made of the fair market value of the wet gas,

nor of taxpayer's *net* income, it remanded with instructions to allow additional evidence as to depletion, and to fix the allowance in accordance with the court's opinion.

SPECIFICATION OF ERRORS TO BE URGED

The court below erred:

1. In holding that the nature of the taxpayer's contracts for a supply of wet gas was such that the taxpayer was entitled to an allowance for depletion, provided it paid less for wet gas under its gas treatment contracts than the market value of such wet gas as established by the current contract price generally being paid in that field under similar contracts entered into during the taxable years.

2. In failing to hold that the taxpayer had no interest in the wet gas in place in the earth which could be the subject of a deduction for depletion.

3. In reversing the decision of the Board of Tax Appeals.

SUMMARY OF ARGUMENT

Depletion represents capital extracted from the property. Ownership of the oil or gas as produced, or of its proceeds, is the basis for recognition of a depletable economic interest in the oil or gas in place. The depletion allowance is a percentage of "gross income from the property," which, as here applied, means gross income from wet gas produced.

The respondent is a processor of wet gas not distinguishable from a refiner of crude oil. Under its contracts it acquired no economic interest in wet

gas in place. The contracts were agreements to purchase from, or treat for, the producers wet gas which the producers extracted from their deposits and which became the personal property of the producers when reduced by them to possession in their gas traps or casingheads. The respondent unquestionably did not own the wet gas as produced. The producers accordingly were the sole recipients of "gross income from the property," and solely entitled to depletion. The respondent at best has a mere economic advantage arising out of favorable contracts with the producers, which will cease whenever the contracts cease to be favorable. It is clearly improper to allow depletion for the wasting of an "investment" which is dependent for its existence upon shifting price trends.

ARGUMENT

The theory of Congress in permitting a deduction for depletion is that it will compensate the owner of a wasting asset for the exhaustion sustained in the production of taxable income. In other words, depletion represents capital extracted from the property. *United States* v. *Ludey*, 274 U. S. 295. Ownership of the mineral in place—a capital interest—is, therefore, a prerequisite of the right to a depletion allowance.

Section 23 (1) of the Revenue Act of 1928, which contains the general authorization of the deduction on account of depletion, provides:

> In the case of mines, oil and gas wells, other natural deposits, and timber, a reason-

> able allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case. * * *

The provision clearly assumes the prerequisite of ownership. The assumption becomes explicit and a test of ownership is furnished in Section 114 (b) (3), which sets forth the basis of percentage depletion:

> In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the *gross income from the property.*

The Government's basic contention in this and the three cases to be argued immediately after it[2] is that only recipients of "gross income from the property"—that is, only owners of gas and oil, *as produced*—have such an ownership of, or interest in, the mineral in place as to entitle them to depletion.

The decisions of this Court have uniformly confined the right to participate in the allowance for depletion to persons entitled to payments out of oil or the gross proceeds of oil, and have permitted the deduction only from the royalty payments themselves or from cash payments which could be regarded as advance royalties paid in anticipation of the extraction of oil. They uniformly recognize that the right thus to share in the oil as it comes

[2] No. 406 (*Helvering* v. *O'Donnell*); No. 446 (*Helvering* v. *Elbe Oil Land Development Co.*); No. 600 (*Helvering* v. *Mountain Producers Corp.*).

from the well is indispensable to ownership of a depletable interest in the oil in place.

The leading case is *Palmer* v. *Bender*, 287 U. S. 551. There the taxpayer in consideration of a purported assignment of oil leases received, in addition to a cash bonus, the right to a stated proportion of all the oil produced and saved. The Government contended that under local law the transaction constituted a sale rather than a sublease. The taxpayer urged the contrary. This Court held (p. 555) that the application of the statute was not to be "controlled or varied by any particular characterization by local law of the interests to which it is to be applied." The statute itself fixes the standard for its application. Concerning that standard, the Court said (p. 557):

> The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, *any interest in the oil in place*, and secures, by any form of legal relationship, income *derived from the the extraction of the oil*, to which he must look for a return of his capital. * * * [Italics supplied.]

Technical legal ownership of the mineral before extraction, the Court held, is not necessary to establish an interest in the oil in place.

> * * * the lessor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of legal interest in the mineral content of the land. It is enough if, by virtue of the

> leasing transaction, he has retained a *right to share in the oil produced.* If so he has an economic interest in the oil, in place, which is depleted by production. [Italics supplied.]

The decision in *Palmer* v. *Bender,* in the Government's view, establishes four propositions: (1) that an interest in oil or gas *in place* is a prerequisite to participation in the depletion allowance; (2) that the existence of such an interest is to be determined by uniform Federal law and not by the peculiarities of local law; (3) that technical legal ownership of the oil or gas *in place* is unnecessary; and (4) that the decisive test of the requisite interest, or ownership, is the right to share in the oil or gas *as produced.*

Later cases have emphasized these elements of the decision. In *Helvering* v. *Twin Bell Oil Syndicate,* 293 U. S. 312, 321, the Court stated that the phrase "gross income from the property" "points only to the gross income from oil and gas." The holding of the *Palmer* case was extended to the situation where the lessee, instead of turning over royalty oil in kind, sold all the oil and paid over the royalty in the form of cash. The decision plainly was predicated upon the same reasoning as in the *Palmer* case. More recently still, in *Thomas* v. *Perkins,* 301 U. S. 655, the Court, in discussing the *Palmer* case, said (p. 661):

> Thus in that case we held assignors' mere stipulation for royalty *out of oil* operated

> to save them an economic interest *in the oil* sufficient to entitle them to deduct from their income derived *from the oil* an allowance for depletion. If Palmer had retained no interest in the oil he would have been entitled to no deduction on account of depletion. *Ownership was essential.* [Italics supplied.]

The Court also pointed out that there is no difference, so far as ownership is concerned, between cost and percentage depletion.

The court below, citing its own decision in *Signal Gasoline Corp.* v. *Commissioner,* 77 F. (2d) 728, and relying upon the decision of this Court in *Palmer* v. *Bender, supra,* held that the respondent, processor of wet gas, was entitled to an allowance for depletion if the price which it paid for wet gas to the producer thereof was less than the fair market value of the wet gas at the gas trap* or casinghead at the time the wet gas was delivered. The court recognized that the right to depletion depends upon an economic interest in oil or gas in place, but its conception of such an interest, as a commentator has said, "would seem to read into the phrase * * * a content not intended by the *Palmer* decision and to give it some indefinite meaning totally divorced from any idea of return of capital assets." See 47 Yale Law Journal 278, 280.

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*A device to separate oil that is carried along with the gas (R. 136).

The theory of the lower court's decision in the instant case is best illustrated by a quotation from its opinion in *Signal Gasoline Corp.* v. *Commissioner, supra* (p. 730):[4]

> It is apparent that if the petitioner's contract was such that it was required to pay the full market value of the wet gas as it was produced by the wells it had no capital investment in the well or in the oil content of the land, and had no advantage over a manufacturer who bought his wet gas on the market other than the exclusive right to the product of the particular wells from which it derived the gas. * * * The person who paid the market price to the lessee or owner would suffer no damage of capital investment in the oil or gas in place under such

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[4] *Signal Gasoline Corp.* v. *Commissioner*, 66 F. (2d) 886, was also based upon *Palmer* v. *Bender*. Whatever may be the validity of the *Signal Gasoline Corp.* decision, it is clearly distinguishable. There, unlike the present case, the casinghead gas manufacturer had paid a substantial consideration for its gas contracts; had taken direct means to induce a larger flow of oil and gas; had extracted wet gas from the wells by various means; and had assisted in drilling wells by furnishing equipment. Concerning the contracts in that case, the court said (p. 889) that they imposed upon the Signal Gasoline Corporation "the obligation to * * * exert forces which would bring the oil and gas up out of the ground." As a result, the court reached the conclusion in the *Signal Gasoline Corp.* case (p. 889), which it could not possibly reach here, that the oil producer and the casinghead gas processor "were both engaged in continuous steps to win oil and casinghead gas from their position in the earth."

The second decision in the *Signal Gasoline Corp.* case, 77 F. (2d) 728, certiorari denied, 296 U. S. 657, involved merely the method of calculation of the depletion allowance.

> circumstances. If we assume, however, that the petitioner by reason of his favorable contract with the producer secures the wet gas when produced at a fraction of its market price at the time it is produced, say one-half for the purpose of illustration, it is clear that petitioner to that extent (50 per cent) would have his interest in the wet gas in place in the land reduced by one-half of the amount produced. * * *

This holding is clearly a misapplication of the principles announced by this Court. See pp. 7–10, *supra*.

Ownership of the oil or gas as produced, or of its proceeds, is the basis for recognition of a depletable economic interest in the oil or gas in place. Where such ownership does not exist, there is no basis for depletion. To repeat what this Court said in *Thomas* v. *Perkins, supra,* in discussing *Palmer* v. *Bender:*

> If Palmer had retained no interest in the oil he would have been entitled to no deduction on account of depletion. *Ownership was essential.*

It is only the owner of the gas or oil as produced, or of its proceeds, who may be said, within the meaning of the statute to receive "gross income from the property"—namely, from the gas or oil. *Helvering* v. *Twin Bell Oil Syndicate, supra.*

The respondent unquestionably, we submit, did not own the wet gas as produced. It did not engage in production of the gas, nor could it com-

pel its production. It was merely entitled by virtue of contract either to purchase the wet gas produced or to process it, retaining a share of the proceeds as compensation for its services. The respondent thus had no right in any particular unit of gas *as produced,* other than the right to have it delivered pursuant to contract. The gas to be purchased had to be paid for. The gas to be processed yielded what was in effect a commission. In this connection the Board said (R. 54):

> It is safe to say, we believe, that this petitioner had no enforceable rights whatsoever under its contracts prior to the time the wet gas was actually placed in its pipe line, i. e., after it had passed beyond the casingheads and gas traps supplied by the producer and into the pipe line, except the right, perhaps, to demand that the producer deliver whatever was produced through its pipe lines for treatment during the period of contractual relationship.

Each of the contracts specifically provided that the oil producer was the owner of the wet gas produced from the oil properties (R. 76–77), or was drawn in terms of purchase of the wet gas by the taxpayer and sale by the oil producer (R. 90, 99, 107, 108).*

In *Hurley* v. *United States,* 10 F. Supp. 365 (N. D. Okla.), it was contended that a casinghead gaso-

* The court below made no distinction between the gas treatment contract and the contract of sale; nor did respondent's witness Taggart (R. 127).

line manufacturer was entitled to depletion. The court said (pp. 367–368):

> In order to come within the quoted section the plaintiff's business must fall within the category of "mines, oil and gas wells." The plaintiff was operating a plant designed to extract gasoline from gas; it was not operating a mine, nor an oil or gas well. * * * it did not own a gas well; it had no interest in the lease, nor in the gas reserves, * * *. It seems to me that this situation is closely analogous to that of an oil refinery, which is constructed for the purpose of refining crude oil. It buys the crude oil from others * * *. * * * the plaintiff, as the operator of the casinghead gas plant, is not entitled to a depletion because of the exhaustion of gas reserves which belong to another. * * * In these cases [*Palmer* v. *Bender*, 287 U. S. 551; *Reynolds* v. *Cooper*, 64 F. (2d) 644 (C. C. A. 10th), affirmed, 291 U. S. 192], the taxpayer had an interest in the minerals "in place"—as lessor, lessee, or the assignee of some interest in the lease, and the court was particular twice to limit its holding to oil "in place." One who buys the oil at the mouth of the oil well owns the oil, but has no interest in it "in place."
>
> * * * * *
>
> Counsel relies upon *Signal Gasoline Corp.* v. *Commissioner*, (C. C. A. 9), 66 F. (2d) 886, which may be distinguished on the facts, since in that case the taxpayer pumped gas after the wells ceased producing oil, a con-

> dition not here present. Here, the vacuum pressure which increased recovery was incidental to the transportation of the gas. The sole authority for this decision is *Palmer* v. *Bender, but the court overlooked entirely the qualifying words "in place" twice used in that opinion.* * * * [Italics supplied.]

This holding, we submit, is correct and applicable here. This respondent had no more interest in the wet gas reserves than an oil refinery has in the oil in place. The producers were the owners of the wet gas and, like the owners of oil produced, were entitled to depletion on one hundred per cent of the gross proceeds therefrom.

The court below has recognized that the mere possession by a casinghead gasoline manufacturer of a contract right to receive the entire product of a particular well does not constitute him the owner of the wet gas as produced. In *Signal Gasoline Corp.* v. *Commissioner,* 77 F. (2d) 728, the court rejected the contention of such a manufacturer that he was entitled to percentage depletion figured upon the gross proceeds of the gasoline and dry gas extracted from the wet gas, less the amount of the "royalties" paid to the producer. Such a claim, the court pointed out, was subject to a double vice. It included in the basis for depletion the value added to the wet gas by the manufacturing process, contrary to the holding of that and other circuit courts of appeals that "gross income from the property" means gross income from the sale of the natural

product at the well only. *Brea Cannon Oil Co.* v. *Commissioner*, 77 F. (2d) 67 (C. C. A. 9th); *Consumers Natural Gas Co.* v. *Commissioner*, 78 F. (2d) 161 (C. C. A. 2d), certiorari denied, 296 U. S. 634; *Greensboro Gas Co.* v. *Commissioner*, 79 F. (2d) 701 (C. C. A. 5th), certiorari denied, 296 U. S. 639. Compare *Helvering* v. *Twin Bell Oil Syndicate*, *supra*. But the contention also treated the manufacturer as the owner of the natural product, the wet gas—just as if he himself were the lessee-operator paying "royalties" to a lessor-owner. This the court said was erroneous if the royalties were equal to the market value of the wet gas. See pp. 11–12, *supra*.

It is manifest, we submit, that if the casinghead manufacturer is not the owner of the wet gas as produced in the case supposed, he does not become the owner *pro tanto* merely because of a contract right to receive the wet gas for less than its market value. The transaction remains one of purchase, though made at a bargain price. In the case of the processing contracts it remains one of agreement for sale of the manufactured product on behalf of the producer, though the commission be specially advantageous. The respondent profits from a favorable contractual position. But it does not receive income "from the property"—in the correct sense of income from the sale of the natural product at the well—to which it must look for a return of its capital. Its interest is wholly one arising out of an advantageous contract.

The holding that such an interest constitutes an economic interest in the mineral in place within the meaning of the decisions of this Court is irreconcilable with the concept of depletion as compensation for the wasting of a capital asset through production of taxable income. That this is so is conclusively shown by the fact that the supposed capital asset would cease the moment the contract ceased to be advantageous. Thus with a return of the prevailing market value to the price fixed by the contract the respondent's "capital investment" would be entirely wiped out. Susceptibility to loss of this character is a mark of a contract of purchase, not of ownership. Clearly it is improper to allow depletion for the wasting of an "investment" which is dependent for its very existence upon shifting price trends.[6]

[6] Wet gas, it is to be noted, is not sold at a price per unit at the mouth of the well, nor is its price stated in terms of dollars and cents. The manufacturer pays for the gas a proportion of the gasoline ultimately extracted (or its proceeds), the proportion presumably varying according to the cost of manufacture and the current price of gasoline as well as the supply of wet gas and, perhaps, the disposition of dry gas (R. 151). The respondent computes its "depletable interest" by deducting the number of gallons of the manufactured products actually paid under the contract (33⅓%) from the number which would have been paid at the going rate (allegedly 45% to 50%) and then determining the market value of the difference (R. 150–152). The court below did not finally determine the propriety of this method of fixing market value of wet gas. Nor did it determine by what method the taxpayer's "net income from the property" should be computed for the purposes of the statutory limitation upon the allowance.

The court below proceeded upon the assumption, implicit in the case at bar and virtually explicit in the *Signal Gasoline Corp.* case, *supra,* 77 F. (2d) at 730, that "gross income from the property" must necessarily equal the market value of the product. It seems evident that the assumption is erroneous. Congress has taken the gross income of the owner from the product as the basis of percentage depletion, not the product's market value. The owner of an oil or gas lease may sell his product under a long-term contract at less than its market value just as the owner of a manufacturing business may do. An economic advantage consisting merely of the contractual right to acquire the natural product at less than its market value no more constitutes ownership of the natural product in place than a similar right with respect to a manufactured product would constitute ownership of the factory.

It cannot in any sense be said in this case that respondent secured "by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital." See *Palmer* v. *Bender, supra,* p. 557. Since it is the mineral deposit which is depleted by production, the respondent whose interest is confined to the extracted mineral is not within the class of "mines, oil and gas wells, other natural deposits, and timber," to which the depletion section alone applies.

CONCLUSION

In view of the foregoing we respectfully submit that the decision of the Circuit Court of Appeals should be reversed.

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JANUARY 1938.

APPENDIX

Revenue Act of 1926, c. 27, 44 Stat. 9:

SEC. 204. * * *

(c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—

* * * * *

(2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

SEC. 234. (a) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

* * * * *

(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the de-

ductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee; * * *

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * *

(*1*) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction shall be equitably apportioned between the lessor and lessee. * * * (For percentage depletion in case of oil and gas wells, see section 114 (b) (3).)

(*m*) *Basis for depreciation and depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(*a*) *Basis for depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in section 113 for the purpose of determining the gain or loss upon the sale or other disposition of such property.

(b) *Basis for depletion.*—

* * * * * *

(*3*) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the

allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

Treasury Regulations 69, promulgated under the Revenue Act of 1926:

ART. 201. *Depletion of mines, oil and gas wells; depreciation of improvements.*—Sections 214 (a) (9) and 234 (a) (8) provide that taxpayers shall be allowed as a deduction in computing net income in the case of natural deposits a reasonable allowance for depletion of mineral and for depreciation of improvements. See section 204 (c) and articles 1602 and 221 with reference to the basis for computing depreciation and depletion.

The essence of these provisions of the statute is that the owner of mineral deposits, whether freehold or leasehold, shall, within the limitations prescribed, secure through an aggregate of annual depletion and depreciation deductions the return of either the cost of his property, or the value of his property on the basic date plus, in either case, subsequent allowable capital additions (see articles 222 and 223), but not including land values for purposes other than the extraction of minerals. (But see section 204 (c) (2) and article 221.)

Operating owners, lessors, and lessees, whether corporations or individuals, are entitled to deduct an allowance for depletion and depreciation, but a shareholder in a min-

ing or oil or gas corporation is not allowed such deductions. (But see article 1546.)

ART. 1602. *Basis for allowance of depletion and depreciation.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence will be allowed in respect of any property is the same as is provided in section 204 (a) and (b) for the purpose of determining the gain or loss from the sale or other disposition of such property, except that:

* * * * *

(2) With respect to oil and gas wells, the allowance for depletion shall be 27½ per cent of the gross income from the property during the taxable year, but such allowance shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. In no case shall the deduction for depletion with respect to oil and gas wells be less than it would be if computed without reference to section 204 (c) (2) and this paragraph.

See articles 201–237 for the methods of computing allowances for depletion, and articles 161–170 with reference to the allowance for depreciation.

Treasury Regulations 74, promulgated under the Revenue Act of 1928:

The applicable Articles of these Regulations are substantially similar to the corresponding Articles in Regulations 69, *supra*, and are not copied here (Cf. Articles 221, 611, Treasury Regulations 74).

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In the Supreme Court

OF THE

United States

OCTOBER TERM, 1937

No. 387

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

BANKLINE OIL COMPANY (a corporation),
Respondent.

RESPONDENT'S REPLY TO PETITIONER'S PETITION FOR CERTIORARI.

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vs.

BANKLINE OIL COMPANY (a corporation),
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RESPONDENT'S REPLY TO PETITIONER'S PETITION FOR CERTIORARI.

To the Honorable Charles Evans Hughes, Chief Justice of the United States, and to the Associate Justices of the Supreme Court of the United States:

In view of the fact that petitioner did not file a brief on the merits in support of its petition for certiorari, we shall limit ourselves in this reply to one or two comments about the salient features of the

problem. Before proceeding, however, we desire to point out that the decision of the Circuit Court of Appeals, which had not been reported at the time of the filing of the two petitions for certiorari in this action, has since been published in 90 Fed. (2d) 899.

I. THE ALLOWANCE OF DEPLETION FOLLOWS NECESSARILY FROM THIS COURT'S DECISION IN PALMER v. BENDER.

The decision of the Court in the instant case follows the decision of the same Court in

Signal Oil & Gas Co. v. Commissioner, 66 Fed. (2d) 886,

a case virtually identical with the instant case. From that decision no petition for certiorari was filed. No other Circuit Court of Appeals has ever rendered a decision to the contrary.

The principle upon which persons in the position of Bankline Oil Company are entitled to an allowance for depletion was established by this Court in its decision in

Palmer v. Bender, 287 U. S. 551.

This Court said, in granting an allowance for depletion to the taxpayer in that case, that any person who has an *economic* interest in the production of oil or gas wells is entitled to an allowance for depletion against that income. The same principle was reaffirmed in

Helvering v. Twin Bell Oil Syndicate, 293 U. S. 312,

and in

Thomas v. Perkins, No. 824, October Term, 1936, decided June 1, 1937, and found in 81 L. Ed., Adv. Op. 870.

The two cases last referred to involve the reverse of the *Palmer v. Bender* situation, and the decisions in all three are entirely consistent.

The decisions of the Ninth Circuit do not in any way extend the principles there established. In none of the cases cited was the taxpayer the operator of the well. However, this Court held that if the taxpayer retained a right to share in the production he retained "an economic interest in the oil in place which is depleted by production".

Palmer v. Bender, 287 U. S. at 557.

An affirmance of this judgment will not, contrary to the contention of the Commissioner, have any effect on the depletion allowances to operators of the wells who furnish natural gas to the Bankline Oil Company. They do not receive the full value of the gas produced and they are entitled to depletion only upon what they receive for their gas. Bankline is endeavoring to obtain depletion upon the difference between the full value of the gas and the amount allowed to the well operators.

II. THE CROSS PETITION FILED BY BANKLINE OIL COMPANY.

As we pointed out in the petition for certiorari filed on behalf of Bankline Oil Company, this case involves two questions of law. Besides the depletion question,

above referred to, Bankline Oil Company claims that the income which it derived from tidelands leased to it on a royalty basis from the State of California is exempt from Federal income taxes. Such an exemption was recognized by this Court in

Burnet v. Coronado Oil & Gas Co., 285 U. S. 393.

Some limitation was placed upon that exemption by the decision in

Burnet v. Jergins Trust, 288 U. S. 508.

However, we submit that it is quite apparent from that opinion that this Court did not intend to overrule its former decision. Inasmuch as the facts in the instant case are so nearly identical with those present in the *Coronado Oil & Gas* case, we respectfully submit that the Circuit Court erred in denying Bankline's claim and in refusing to follow the principles which this Court had established.

In conclusion, we submit that if this Court should determine to review any portion of the decision of the Circuit Court of Appeals, it should review that portion denying to Bankline Oil Company exemption from Federal taxation of income received from a state tideland lease.

Dated, Los Angeles, California,
October 4, 1937.

Respectfully submitted,

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IN THE

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October Term, 1937
No. 387.

GUY T. HELVERING, Commissioner of Internal Revenue,
Petitioner,

vs.

BANKLINE OIL COMPANY, a corporation,
Respondent.

BRIEF FOR RESPONDENT.

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IN THE

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October Term, 1937
No. 387.

GUY T. HELVERING, Commissioner of Internal Revenue,
Petitioner,

vs.

BANKLINE OIL COMPANY, a corporation,
Respondent.

BRIEF FOR RESPONDENT.

Restatement of Question Presented.

The sole question for the determination of this Court is whether respondent, by virtue of the contracts which it entered into, and by which it acquired the right to all of the gas produced from certain oil and gas wells, acquired an economic interest in the gas produced from those wells, upon which it is entitled to an allowance for depletion.

Statement of the Case.

Starting in the year 1922 and during the three years in question, to-wit, 1927, 1928 and 1930, respondent, Bankline Oil Company, operated a casinghead gasoline plant in Signal Hill Oil Field, Los Angeles County, California. On January 9th of that year it entered into a contract with General Petroleum Corporation [R.

107-115] by the terms of which it agreed to construct, within ninety (90) days, a casinghead gasoline plant in the Signal Hill oil district. When the plant was completed General Petroleum Corporation agreed to deliver to Bankline at the gas traps or casingheads all gas produced from wells operated by General Petroleum in the Signal Hill area. Bankline in turn agreed to treat the gas so received and to pay the General Petroleum a royalty of 33⅓ per cent of the gasoline extracted.

On October 25, 1923, respondent entered into three contracts with the United Oil Company on substantially the same terms. On May 22, 1925, it made a similar contract with the Superior Oil Company for the treament of its gasoline, and on October 29, 1928, one with the Richfield Oil Company for the same purpose. Each of the contracts called for the payment of a 33⅓ per cent royalty.

The gasoline delivered under the contracts last mentioned constituted a relatively small percentage of the products treated in respondent's plant. As will be seen by an examination of "Exhibit 8" [R. 118-120], over 75 per cent of all the gas treated in the plant was treated under respondent's contract with General Petroleum.

In accordance with the provisions of the contracts, respondent attached pipelines to the various wells, carried the gas from those wells to its plant, where the gas from the wells of the different operators was commingled, and removed the gasoline therefrom. The gasoline manufactured was sold, and respondent accounted to each producer for one-third of the proceeds of the producers' *pro rata* of the gasoline made. A large part of the dry gas remaining after the removal of the gasoline was blown into the air because there was no market for it. Some of the dry gas was sold to public utilities, in which case respondent

paid the producer for his *pro rata*, and some of the dry gas was returned for injection into the various wells that had been depleted by a long period of production. This injection was for the purpose of repressuring, and to cause wells, on which the pressure had declined, to continue to produce additional quantities of oil and gas.

It leads to a misconception to state that wet gas is never sold at the mouth of the well. It is true to say that it is not sold at so many cents per thousand feet. Invariably a gasoline absorption company is given the right to remove it, and, for that privilege, it pays the owner of the well a share of the gasoline recovered and a share of the dry gas residuum sold. [R. 121, 125, 133.]

During the years in question, the prevailing rate of royalty was considerably higher than the 33⅓ per cent which Bankline had agreed, in its contracts, to pay. In 1927 it was 45 per cent; in 1928, 47½ per cent; and by 1930 had increased to 50 per cent. There is no dispute about this fact, for it was testified to by respondent's witnesses, J. Lee Cross [R. 121], T. L. Taggart [R. 126], and John McFarland [R. 127], all of whom showed knowledge and familiarity with conditions. The conclusion was confirmed by Baxter, the only witness for petitioner. [R. 134.]

Therefore, if respondent's contentions are correct, it is entitled to an allowance for depletion computed in the following manner:

	Value of Gasoline Recovered	Contract Royalty	Prevailing Royalty	Depletable Interest	Depletion
1927	$626,494.68	$208,831.67	$281,922.61	$ 73,090.94	$20,100.00
1928	769,633.55	256,544.33	365,575.94	109,031.61	29,983.69
1930	390,596.48	130,257.68	195,298.24	65,040.56	17,886.15

The Commissioner determined deficiencies against respondent, and respondent appealed to the Board of Tax Appeals, contending that it was entitled to deduct, as percentage depletion, 27½ per cent of the difference between the price which it paid for the wet gas and its fair market value at the mouths of the wells.

As stated by petitioner in its brief, the Board of Tax Appeals held that under its contracts respondent acquired no depletable interest in the gas production. However, the Circuit Court of Appeals determined that the contracts were sufficient to give respondent an economic interest in the wet gas in place, and that it was entitled to an allowance for depletion. The Court remanded the case to the Board of Tax Appeals for the purpose of taking further testimony upon the question of the amount of depletion.

From that decision the Commissioner applied for certiorari.

Summary of Argument.

In order to establish a right to an allowance for depletion, a taxpayer need only show that he has a right to share in oil or gas as produced or, in other words, that he has an economic interest in the production. He need not show that he has technical legal title to the oil or gas in place.

The holder of a contract entitling him to all of the gas produced during the life of a certain well has such an interest. He is more than a mere purchaser of the gas after it is produced. If the contract calls for the payment of less than the prevailing royalty for the gas, he has an income from production upon which he is entitled to a deduction for depletion.

ARGUMENT.

I.

Respondent Had an Economic Interest in the Gas in Place.

It has long been recognized that the supply of oil and gas, like the supply of other natural resources, is not unlimited. Each time a barrel of oil or a thousand cubic feet of gas is removed from the earth, the future recovery from that particular property is reduced *pro tanto*. For that reason Congress, long since, has recognized that it would be improper to tax, as income, the whole amount of money received by those entitled to the products of oil wells. It has therefore provided that those who have an interest in oil and gas wells shall be entitled to an allowance for depletion.

See:

Revenue Act of 1926 (c. 27), 44 Stat. 9, Sec. 204 (c 1, 2), 234 (a 8);

Revenue Act of 1928 (c. 852), 45 Stat. 791, Sec. 23 (m 1), 114 (b 2, 3);

(Set forth in Appendix, pp. 19 to 22.)

The Government has almost continually, since its enactment, sought to limit this allowance for depletion to a very narrow class of persons. However, this Court has consistently refused to allow such limitations. In one of its relatively early income tax decisions, the Court determined that the depletion allowance was not confined to the actual operator of the well.

Lynch v. Alworth-Stephens Co., 267 U. S. 364, 370.

Respondent was the lessee of a mine and had agreed to pay the owner a royalty. It subleased the mine to a third party, reserving to itself a royalty over and above that to be paid to the lessor. Upon the income received, respondent claimed an allowance for depletion. The Government contended that only the owner of the fee had a sufficient interest in the minerals to secure such an allowance. This Court refused to recognize the Government's contention and, in affirming the judgment in favor of respondent, said:

> "It is said that the depletion allowance applies to the physical exhaustion of the ore deposits, and since the title thereto is in the lessor, he alone is entitled to make the deduction. But the fallacy in the syllogism is plain. The deduction for depletion in the case of mines is a special application of the general rule of the statute allowing a deduction for exhaustion of property. *While respondent does not own the ore deposits, its right to mine and remove the ore and reduce it to possession and ownership is property within the meaning of the general provision.* Obviously, as the process goes on, this property interest of the lessee in the mines is lessened from year to year, as the owner's property interest in the same mines is likewise lessened. There is an exhaustion of property in the one case as in the other; and the extent of it, with the consequent deduction to be made, in each case, is to be arrived at in the same way; namely, by determining the aggregate amount of the depletion of the mines in which the several interests inhere, based upon the market value of the product, and allocating that amount in proportion to the interest of each, severally considered." (Italics ours.)

Subsequently the doctrine was extended by the case of

Palmer v. Bender, 287 U. S. 551, 557.

Petitioner was a member of two partnerships which had drilled for and discovered oil on property in Louisiana. Thereafter the partnerships assigned the lease in consideration of the payment of a certain sum in cash, a further payment of $1,000,000 to be paid out of one-half of the oil produced, and an additional one-eighth royalty. Petitioner claimed the right to take depletion upon the amounts paid to him out of oil, but the Commissioner contended that, inasmuch as the transactions constituted sales of the interests, petitioner had no interest in the production of the oil and was, therefore, not entitled to a depletion allowance.

This Court held that, although he was not technically a lessor, petitioner was entitled to an allowance for depletion upon the bonus and royalties received by him.

> "The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital.
>
> "That the allowance for depletion is not made dependent upon the particular legal form of the taxpayer's interest in the property to be depleted was recognized by this Court in Lynch v. Alworth-Stephens Co., 267 U. S. 364; 69 L. Ed. 660, 45 S. Ct. 274. There a depletion allowance under Paragraph 12(a) of the 1916 Act, (September 8) 39 Stat. at L. 767, Chap. 463, was claimed by a lessee of a mining lease, in the computation of tax on income from the proceeds of ore mined. The statute made no specific

reference to lessees and the Government argued that as the lessee acquired no ownership of the ore until the severance from the soil (see United States v. Biwabik Min. Co., 247 U. S. 116, 123, 62 L. Ed. 1017, 1020, 38 S. Ct. 462), the lease gave him no depletable interest in the ore in place. But this Court held that regardless of the technical ownership of the ore before severance, the taxpayer, by his lease, had acquired legal control of a valuable economic interest in the ore capable of realization as gross income by the exercise of his mining rights under the lease. Depletion was, therefore, allowed.

"Similarly, the lessor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of legal interest in the mineral content of the land. *It is enough, if by virtue of the leasing transaction, he has retained a right to share in the oil produced. If so he has an economic interest in the oil, in place, which is depleted by production.*" (Italics ours.)

See also, to the same effect:

Commissioner v. Williams, 82 Fed. (2d) 328, 329; C. C. A. 5.

"One has an economic interest in oil, in place, whether the interest he has retained is a right to share in the oil produced or a right to share in the proceeds of the sale of the oil produced."

***Thomas v. Perkins*, 301 U. S. 655;**

***Helvering v. Twin Bell Oil Synd.*, 293 U. S. 312;**

***Herring v. Commissioner*, 293 U. S. 322;**

***Helvering v. Falk*, 291 U. S. 183;**

United States v. Biwabik Mining Co., 247 U. S. 116;

Obispo Oil Co. v. Welch, 85 Fed. (2d) 860; C. C. A. 9;

Commissioner v. Elliott Petroleum Corp., 82 Fed. (2d) 193; C. C. A. 9;

Commissioner v. Fleming, 82 Fed. (2d) 324; C. C. A. 5.

We submit that the foregoing decisions of this Court compel a decision in favor of Bankline Oil Company. That Bankline acquired, by virtue of its contracts, a right to share in the gas produced must be clear.

As pointed out in the statement of facts, Bankline was given the right to all of the gas that was ever produced from the wells in question. It was obligated to install meters for the measurement of gas coming from each property [R. 112], and had the right, whenever necessary, to maintain vacuums on the wells for the purpose of assisting in the production of gas that would not otherwise be produced. [R. 110.] It was also obligated to return to the producer the dry gas remaining after the extraction of the gasoline. [R. 112.] This residual dry gas was used, in part, for injection into wells to increase their productivity after the pressure had declined. Such injection, known as the gas lift, results in an increased production of both oil and gas.

It may be noted that gas contracts of the type involved in the instant case bear no analogy to the purchase of oil by a refiner. Oil is either purchased on day to day arrangements or on short term contracts. Invariably they provide for payment at the posted price or at the market price. Furthermore, the oil may be transported by pipe-

line or otherwise and treated at remote refineries that can draw their raw materials from widely separated areas.

On the other hand, casinghead gasoline absorption plants must be situated in or close to the fields where the gas is produced. They become useless when the gas in that field is exhausted. The operator builds his plant in reliance on contracts that assure him of a supply of gas for the life of the field. He has, for a valuable consideration, to-wit, building a plant

> *"acquired legal control of a valuable economic interest."*
>
> *Palmer v. Bender, supra.*

The interest which respondent acquired in the gas to be produced out of the wells in question was an even greater interest than the one acquired by the taxpayer in *Palmer v. Bender, supra.* Palmer had only the right to receive a fixed sum of money. Unless the wells produced less than enough to pay him his $1,000,000.00, he had no interest in the ultimate amount of oil produced. His interest in production was, therefore, more or less nebulous and contingent.

Respondent, on the other hand, had a direct and vital interest in the ultimate recovery of gas from its wells. It had a right to share in the gas produced. Each day's production of gas reduced the amount it could expect to receive in the future. Consequently, as stated by the Circuit Court of Appeals in deciding the instant case, respondent

"had a definite economic interest in the oil (gas) in place, upon which it was entitled to an allowance for depletion."

Bankline Oil Company v. Commissioner, 90 Fed. (2d) 899; C. C. A. 9.

The same court had reached a similar decision in

Signal Gasoline Corporation v. Commissioner, 66 Fed. (2d) 886, 890; C. C. A. 9.

Signal was in the same business as is Bankline. The contracts which it had were substantially similar to those of respondent, and the Court held it had depletable interest, saying:

"Accordingly, the right to a depletion allowance does not depend upon the nature or character of the legal estate retained or acquired by the parties to an original oil and gas lease or their successors, but depends entirely upon whether any such parties are entitled to share in the oil and gas produced from the properties. If any of such parties are entitled to a share of the oil and gas, he had the 'economic interest' upon which the Supreme Court bases the right to a depletion allowance.

"Applying the principle as established by the Supreme Court, it seems clear that the interest of petitioner was included within the meaning of the statute, permitting deduction of a reasonable allowance for depletion, according to the peculiar conditions in this case."

The Commissioner took no appeal from that decision. In the hearing before the Circuit Court of Appeals in the instant case the Commissioner sought to point out alleged distinctions between the position of the Bankline Oil Com-

pany and that of the Signal Gasoline Corporation. However, the Court held that the contracts of the two corporations were substantially similar, and that both had an economic interest in the gas in place.

We therefore submit that by virtue of its contracts respondent acquired an economic interest in the gas to be thereafter produced and was entitled to an allowance for depletion.

II.

Comments on the Argument of Petitioner.

The argument advanced by petitioner is based upon a contention often repudiated by this Court. The petitioner claims that in order to establish a claim for depletion the taxpayer must show that title to the oil and gas in place is vested in him. This is not the law.

Thomas v. Perkins, 301 U. S. 655, 659.

> "We need not decide whether technical title to the oil while in the ground was in assignors, or assignees."

Palmer v. Bender, 287 U. S. 551, 557.

> "Similarly, the lessor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of legal interest in the mineral content of the land. *It is enough, if by virtue of the leasing transaction, he has a right to share in the oil produced. If so he has an economic interest in the oil, in place, which is depleted by production.*" (Italics ours.)

Petitioner seems to be confusing ownership, as used in its technical legal sense, with the right to share in oil or gas produced.

We submit that, under its contracts with the owners of the wells, respondent acquired a right to share in the gas produced. As we have pointed out, this right to share in the gas as produced gives to the person who has that right an economic interest in the gas in place, and therefore a right to depletion.

Petitioner argues, however, that Bankline was merely in the position of a purchaser of wet gas after it was produced. We believe that an examination of its contracts [R. 76-115] will show that the interest conveyed to respondent was greater than a mere right of purchase. Respondent was given the exclusive right to *all gas produced* from the designated properties *as long as gas was available*. It was given the right to go to the wells and remove the gas. It also had the right to create vacuums to increase the flow of gas. By agreeing to convey such rights, the operator of the well is in reality surrendering all interest he may have in the gas except the royalty he reserves.

Such agreements place respondent in a position very similar to that of a sublessee under an oil lease. The sublessee, in consideration of the payment by him of a certain fixed royalty, is given the right to the oil and gas produced from a designated property. Similarly respondent, in consideration of the payment by it of a fixed royalty, is given the right to all gas produced from designated wells. The grant of such a right constitutes far more than an agreement of sale. It gives respondent the right to share in the gas as produced.

Even if respondent was in the position of a purchaser of gas, it would still have an economic interest in the ultimate production in view of the nature of its contracts, which entitle it to *all* of the gas produced from the various

wells. Its interest is certainly far more direct and more closely connected with the ultimate production than was the interest of the taxpayer in *Palmer v. Bender, supra,* and in other cases decided upon the principle there established. As we have already pointed out in the preceding portion of this brief, a person who was entitled to a fixed sum of money, payable out of oil, is not actually interested in the ultimate production from the property. On the other hand, a man who has built a plant for the sole purpose of treating the products coming from that well has as great an interest in the production as the person who has drilled the well, or who receives a royalty.

The next contention of petitioner is that there can be no right to depletion because the right disappears the moment that the prevailing market price of the gas drops to, or below, the price stipulated in the contract. In raising that point we believe that the petitioner has misconceived the contention of the respondent and the opinion of the Circuit Court of Appeals. He is confusing the right to a depletion allowance with the amount of the allowance.

It is our contention that Bankline Oil Company has, by virtue of its contracts, an economic interest in the gas in place in the well and therefore has a depletable interest, regardless of relative prices. However, only when the prevailing royalties, established in the open market, are above the royalties stipulated in the contract does respondent receive an income from production upon which to compute its depletion allowance.

If, by virtue of its contracts, respondent is required to pay the prevailing royalty for the gas which it removes from the wells, it has no gross income from production upon which to base its 27½ per cent depletion allowance.

It is in the same position as the man who has drilled an unproductive oil well—he has a right to depletion but no income on which to take it. Only when the prevailing royalty for gas is above the amount respondent is required to pay, does respondent receive income from the production of gas. Only then has it established a basis upon which to compute a depletion allowance.

Conclusion.

The respondent has established that it has a right to share in the oil produced. It therefore stands in the same position as others whom this Court has determined have a right to depletion.

The Circuit Court of Appeals, though reversing the judgment of the Board of Tax Appeals, refused to determine the amount of depletion to which respondent was entitled on the ground that that was a matter of fact on which the Board should make a finding.

We respectfully submit that this Court should affirm that judgment of the Circuit Court of Appeals, and remand the case to the Board of Tax Appeals to find the amount of depletion to which respondent is entitled.

Dated, Los Angeles, California, January 31, 1938.

Respectfully submitted,

A. L. WEIL,

Counsel for Respondent.

MARTIN J. WEIL,

Of Counsel.

APPENDIX.

Revenue Act of 1926, c. 27, 44 Stat. 9:

SEC. 204. * * *

(c) The basis upon which depletion, exhaustion, wear and tear, and absolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—

(c) (1) In the case of mines discovered by the taxpayer after February 28, 1913, the basis for depletion shall be the fair market value of the property at the date of discovery or within thirty days thereafter, if such mines were not acquired as the result of purchase of a proven tract or lease, and if the fair market value of the property is materially disproportionate to the cost. The depletion allowance based on discovery value provided in this paragraph shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property upon which the discovery was made, except that in no case shall the depletion allowance be less than it would be if computed without reference to discovery value. Discoveries shall include minerals in commercial quantities contained within a vein or deposit discovered in an existing mine or mining tract by the taxpayer after February 28, 1913, if the vein or deposit thus discovered was not merely the uninterrupted extension of a continuing commercial vein or deposit already known to exist, and if the discovered minerals are of sufficient value and quantity that they could be separately mined and marketed at a profit.

(c) (2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (Computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

SEC. 234. (a) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

* * * * * * * * *

(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee; * * *

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * * * * *

(1) Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such rea-

sonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction shall be equitably apportioned between the lessor and lessee. * * * (For percentage depletion in case of oil and gas wells, see section 114 (b) (3).)

(m) Basis for depreciation and depletion.—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) Basis for depreciation.—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in section 113 for the purpose of determining the gain or loss upon the sale or other disposition of such property.

(b) (2) *Discovery Value in Case of Mines.*—In the case of mines discovered by the taxpayer after February 28, 1913, the basis for depletion shall be the fair market value of the property at the date of discovery or within thirty days thereafter, if such mines were not acquired as the result of purchase of a proven tract or lease, and if the fair market value of the property is materially disproportionate to the cost. The depletion allowance based on discovery value provided in this paragraph shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property upon which the discovery was made, except that in no case shall the depletion allowance be less than it would be if computed without reference to discovery value. Discoveries shall include minerals in commercial quantities

contained within a vein or deposit discovered in an existing mine or mining tract by the taxpayer after February 28, 1913, if the vein or deposit thus discovered was not merely the uninterrupted extension of a continuing commercial vein or deposit already known to exist, and if the discovered minerals are of sufficient value and quantity that they could be separately mined and marketed at a profit.

(b) (3) *Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

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In the Supreme Court

OF THE

United States

OCTOBER TERM, 1937

No. 388

BANKLINE OIL COMPANY (a corporation),
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI
to the United States Circuit Court of Appeals
for the Ninth Circuit
and
BRIEF IN SUPPORT THEREOF.

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In the Supreme Court
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OCTOBER TERM, 1937

No. .

BANKLINE OIL COMPANY (a corporation),
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI
to the United States Circuit Court of Appeals for the Ninth Circuit.

To the Honorable Charles Evans Hughes, Chief Justice of the United States, and to the Associate Justices of the Supreme Court of the United States:

Your petitioner respectfully submits the following:

(a) STATEMENT OF THE MATTER INVOLVED:

The question here involved is whether petitioner is obligated to pay income taxes to the United States,

under Sections 12 and 22 of the Revenue Act of 1928, upon income derived by it from property owned by the State of California and leased by said state to petitioner upon a royalty basis.

(b) **REASONS RELIED ON FOR ALLOWANCE OF THE WRIT:**

In rendering its opinion in the instant case, the Circuit Court of Appeals refused to follow the case of *Burnet v. Coronado Oil & Gas Co.,* 285 U. S. 393, in which this Court held such income was exempt from federal income tax.

It is the contention of petitioner that the facts in the instant case are virtually identical with the facts in *Burnet v. Coronado,* supra.

The Circuit Court of Appeals, in refusing to follow the principle established in the *Coronado* case, but, on the contrary, holding that income received from operations upon a state tideland lease is taxable, committed error.

The Circuit Court of Appeals based its decision against petitioner upon *Burnet v. Jergins Trust,* 288 U. S. 508, which petitioner contends did not involve a situation at all comparable to the instant case.

A concise statement of the case and an argument in support of this petition are contained in the supporting brief. In that brief both of the cases referred to are discussed at length.

Wherefore petitioner respectfully prays that this Court will issue a writ of certiorari to the Circuit

Court of Appeals for the Ninth Circuit in order that the judgment of that Court in this case may be reviewed and corrected.

Dated, San Francisco, California,
September 3, 1937.

A. L. WEIL,
Counsel for Petitioner.

MARTIN J. WEIL,
Of Counsel.

CERTIFICATE OF COUNSEL.

I hereby certify that I am of counsel for petitioner in the above entitled cause and that in my judgment the foregoing petition is well founded in point of law as well as in fact and that said petition is not interposed for delay.

Dated, San Francisco, California,
September 3, 1937.

A. L. WEIL,
Of Counsel for Petitioner.

In the Supreme Court
OF THE
United States

OCTOBER TERM, 1937

No.

BANKLINE OIL COMPANY (a corporation),
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

STATEMENT DISCLOSING BASIS OF JURISDICTION.

(a) The statutory provision sustaining the jurisdiction of this Court to allow the writ of certiorari prayed for is contained in Section 240 of the Judicial Code. See also United States Code Annotated, Title 28, Section 347.

(b) The decision and order of the United States Board of Tax Appeals in the above entitled matter was made and entered on March 28, 1936.

(c) The opinion of the Circuit Court of Appeals was rendered and filed on June 7, 1937. To date it has not been reported, but a copy thereof is set forth in the appendix attached to this brief.

(d) No petition for a rehearing by the Circuit Court of Appeals was filed.

(e) In the opinion of counsel for petitioner, the judgment of the Circuit Court of Appeals upon that portion of the case which was decided adversely to the Commissioner of Internal Revenue, is not a final judgment.

Simmons Co. v. Grier, 258 U. S. 82;
Louisiana Navigation Co. v. Oyster Commission, 226 U. S. 99;
Keystone Manganese Co. v. Martin, 132 U. S. 91.

Counsel believes that the expressed policy of this Court against hearing cases piecemeal may preclude it from granting either petition in the instant case.

Arnold v. U. S., 263 U. S. 427;
Collins v. Miller, 252 U. S. 364.

However, due to the fact that the questions here involved are not in any way connected, but are entirely separate and distinct, and that the decision upon the portion of the case involved in this petition is unquestionably final, counsel believes that possibly this Court may desire to take jurisdiction of the cause at the present time to avoid further protraction of the litigation.

U. S. v. River Rouge Improvement Co., 269 U. S. 411;
Spiller v. A. T. & Santa Fe Ry. Co., 253 U. S. 117;
American Construction Co. v. Jacksonville, etc. Ry., 148 U. S. 372.

STATEMENT OF THE CASE.

This action was instituted by petitioner in the United States Board of Tax Appeals for the recovery of certain overpayments in income tax made by petitioner for the calendar years 1927, 1928 and 1930. It involved two entirely separate and unrelated questions.

In so far as the question involved in this petition is concerned, the suit was brought for the recovery of income taxes charged against petitioner for the year 1930 upon income derived by petitioner from an oil and gas lease from the State of California. Petitioner claimed that that portion of its income was exempt from taxation, but the Board of Tax Appeals ruled that it was taxable. The Circuit Court of Appeals affirmed the judgment against petitioner.

In another portion of the case petitioner claimed the right to an allowance for depletion upon certain contracts made by petitioner for the extraction of casinghead gasoline from wet gas produced from oil wells. The Circuit Court of Appeals held that petitioner was entitled to such a deduction. It reversed the judgment of the Board of Tax Appeals to the contrary and remanded the case to the Board to find the amount of depletion which petitioner was entitled to deduct. We were advised that the Commissioner is applying for certiorari from that decision. However, in this brief we will confine ourselves to a discussion of the question first set forth.

THE FACTS.

The facts applicable to the particular question involved in this petition are entirely without dispute. In fact, they were the subject of a stipulation entered into between counsel for petitioner and counsel for the Commissioner of Internal Revenue prior to the hearing before the Board of Tax Appeals.

On October 22, 1929, the State of California leased certain oil and gas lands pursuant to Chapter 303, Statutes of California, 1921, approved May 21, 1921, entitled "An Act to Reserve all Minerals in State Lands, etc.", situated in the County of Santa Barbara, Santa Barbara, California, to H. J. Barneson, reserving to itself royalty. The lease covered lands situated below the high tide line, and is known as Lease No. 89, or the Elwood Lease.

The statute referred to provides in Section 4 for the issuance of prospecting permits. Section 5 of the Act provides that a permittee, upon establishing to the satisfaction of the Surveyor General that oil and gas in commercial quantities has been discovered on the permit lands, shall be entitled to a lease on the lands embraced in the permit. The section further provides that

> "such lease shall be for a term of twenty years upon a royalty of five per centum in amount or value of the production * * *"

The Act also provided that prior to the issuance of a lease the lessee

> "shall pay to the State of California twenty per centum of the gross value of all oil or gas secured

by him from the lands embraced within this permit * * *"

At the time of the issuance of the lease, Barneson was a vice-president and director of petitioner and was acting on its behalf in acquiring the lease. On November 14, 1929, Barneson and his wife assigned all of their right, title and interest to the lease to Bankline Oil Company. This assignment was approved by the State of California on December 19, 1929.

On acquiring the lease, petitioner immediately commenced drilling operations. Those operations were successful and resulted in the discovery of oil which petitioner produced during all of 1930. During 1930 its net income as a result of the production from Lease No. 89 was $139,014.28.

SPECIFICATION OF ERROR.

Your petitioner respectfully submits that the Circuit Court of Appeals committed error in refusing to follow the decision of this Court in *Burnet v. Coronado Oil & Gas Co.*, 285 U. S. 393, and in determining that the income of petitioner as the lessee of oil and gas lands from the State of California was subject to taxation under the Revenue Act of 1928.

ARGUMENT.

In support of its contention petitioner presents the following propositions of law:

1. A tax upon the income of a lessee of state tidelands, under an oil and gas lease reserving a royalty to the state, is a tax upon an instrumentality of the state and is therefore improper.

2. The State of California holds its tidelands in a governmental capacity in trust for the benefit of the general public.

3. This Court in deciding *Burnet v. Jergins Trust,* 288 U. S. 508, did not, and did not intend to, overrule its decision in *Burnet v. Coronado Oil & Gas Co.,* 285 U. S. 283.

I.

A TAX UPON APPELLANT'S INCOME FROM LEASE NO. 89 IS A TAX UPON AN INSTRUMENTALITY OF THE STATE OF CALIFORNIA AND IS UNCONSTITUTIONAL.

One of the primary principles, upon which the Constitution of the United States was founded, was that there should be a division of powers between the United States on the one hand and the several sovereign states on the other. In order to carry out that principles, it was established very early in our judicial history that neither a state nor the United States could tax the property or the governmental agencies or instrumentalities of the other.

McCulloch v. Maryland, 4 Wheat. 316;

Weston v. Charleston, 2 Pet. 449;

The Collector v. Day, 11 Wall. 113;
Northwestern Mutual Life Insurance Co. v. Wisconsin, 275 U. S. 136;
Macallen Co. v. Massachusetts, 279 U. S. 620;
Indian Motorcycle Co. v. United States, 283 U. S. 570.

This rule is based upon the principle that a tax by the United States on one of the instrumentalities of the state is a direct burden upon, and an interference with, the state's exercise of its sovereign powers. That such interference exists when the income of a lessee under an oil and gas lease from a state is subjected to federal income taxes was recognized by the Supreme Court in

Burnet v. Coronado Oil & Gas Co., 285 U. S. 393, 400,

a case virtually identical to the instant case. The State of Oklahoma had issued an oil and gas lease to the Coronado Oil & Gas Co. The United States sought to levy an income tax upon the income derived by the Coronado Oil & Gas Co. from that lease. The Supreme Court held that that portion of the company's income that was received from the state lease was exempt from taxation, saying:

> "When Oklahoma undertook to lease her public lands for the benefit of the public schools she exercised a function strictly governmental in character. * * *
>
> "Here the lease to the respondent was an instrumentality of the State for the purpose of carrying out her duty in respect of public schools. To tax the income of the lessee arising therefrom

would amount to an imposition upon the lease itself."

Gillespie v. Oklahoma, 257 U. S. 501;
Indian Territory Illuminating Oil Co. v. Oklahoma, 240 U. S. 522;
Chocktaw v. Harrison, 235 U. S. 292.

In order to induce a person or a corporation to prospect lands for oil, a landowner must offer his prospective lessee an opportunity to make a reasonable profit from his operations, should they be successful. The drilling of oil wells, particularly on tidelands, is a very expensive proposition. The risk is great, for there is always the possibility that a well will be dry, in which event the entire investment is lost. Consequently no person would undertake such a venture unless he was assured that, if his efforts were crowned with success, he would make a sufficient profit to compensate him for the risk involved. One of the important elements considered by a prospective lessee who is trying to estimate his possible return on a particular lease, is the amount of royalties he will have to pay to his landowner.

The exemption from taxation of the profits derived from oil operations on state lands has a direct bearing upon the amount of royalties which the state as landowner can exact from its lessees. If the income of the state's lessee is exempt from federal income taxes, the state would be in a position to charge its lessees a higher royalty than it could otherwise collect. Economically the lessee could afford to increase the royalty paid to the state by the amount which he would

otherwise be required to pay as income taxes. To put it in another way, if the state's lessee were required to pay income taxes to the United States, his ultimate margin of profit, out of which his royalties would be paid, would be reduced. The amount of royalties he could afford to pay would be similarly reduced.

> *Gillespie v. Oklahoma,* 257 U. S. 501, 506.
>
> "The same considerations that invalidate a tax upon the lease invalidate a tax upon the profits of the lease; and, stopping short of theoretical possibilities, a tax upon such profits is a direct hamper upon the effort of the United States to make the best terms that it can for its wards."

Thus it is apparent that the tax, sought to be imposed upon petitioner as lessee of Lease No. 89 from the State of California, is a direct imposition upon the lease itself. That lease being an instrumentality of the state, the tax imposes a burden upon that instrumentality, and is therefore an unconstitutional levy.

> *Burnet v. Coronado Oil & Gas Co.,* 285 U. S. 393.

II.

THE STATE OF CALIFORNIA HOLDS ITS TIDELANDS IN A GOVERNMENTAL CAPACITY.

When the original thirteen states joined together to form the Union, title to tidelands was reserved to them. Similarly, when California was admitted to the Union title to the tidelands bordering on its shores

passed from the United States, which had held them since they were acquired from Mexico, to the state.

Borax Consolidated v. City of Los Angeles, 296 U. S. 10.

Those lands are held by the state in trust for the benefit of the people.

Illinois Central Railroad Co. v. Illinois, 146 U. S. 387.

This Court, in referring to the lands under the navigable water of Lake Michigan, said:

> "But it is a title different in character from that which the state holds in lands intended for sale. It is different from the title which the United States hold in the public lands which are open to pre-emption and sale. It is a title held in trust for the people of the state." (p. 452.)

And a little later, on page 453, referring to the disposal of these lands, they continued:

> "Such abdication is not consistent with the exercise of that trust which requires the government of the state to preserve such waters for the use of the public. The trust devolving upon the state for the public, and which can only be discharged by the management and control of property in which the public has an interest, cannot be relinquished by a transfer of the property. The control of the state for the purposes of the trust can never be lost. * * *"

Heckman v. Swett, 99 Cal. 303.

> "Navigable streams and the shores to ordinary high-water mark are held by the state in trust for the public;"

Ward v. Mulford, 32 Cal. 365, 372.

"The land which the state holds by virtue of her sovereignty, as is well understood, is such as is covered and uncovered by the flow and ebb of the neap of ordinary tides. Such land is held by the state in trust and for the benefit of the people."

See also:

Oakland v. E. K. Wood Lumber Co., 211 Cal. 16, 23;

Boone v. Kingsbury, 206 Cal. 148;

People v. Goldrun Mining Co., 66 Cal. 138, 151.

Inasmuch as the foregoing rule is a rule of property in California, the Federal Courts will follow the rule as adopted by the courts of California.

United States v. Mission Rock Co., 189 U. S. 391.

While the state may dispose of its property to private individuals, it can only do so when the use to which the individual proposes to put the property is for the benefit of, and not inconsistent with, the public trust on which the property is held by the state.

Weber v. State Harbor Commissioners, 18 Wall. 57;

Boone v. Kingsbury, 206 Cal. 148;

Forestier v. Johnson, 164 Cal. 24;

Heckman v. Swett, 99 Cal. 303;

Taylor v. Underhill, 40 Cal. 471.

In

Boone v. Kingsbury, supra,

the California Supreme Court had under consideration the constitutionality of the very act under which

Lease No. 89 was granted. They held that the granting of leases to state tidelands would not affect in any way the title of the state and would not alter its trust relationship, saying, on page 182:

> "The license or privilege authorizing the permittee to prospect and mine tide-lands is denominated by the act a lease, but in practical effect *it strongly partakes of the character of a contract to prospect or mine said tide-lands on a share or percentage basis.* In no sense does the state part with title to its tide-lands. * * *"
>
> "The license or privilege or leasehold by which the permittees are granted the right to explore and mine for gas and oil does not constitute a grant or sale of tide-lands in the sense that those terms are used in the prohibitory provisions of article XV, section 3, state constitution."

and again on page 193:

> "In concluding, it may be helpful to observe that Florida, Texas, Louisiana, Oklahoma, and other states have adopted statutes strikingly similar to our statute, in recognition of the public benefit that will accrue to the commonwealth by the developing of the phosphates, gas, oil and other mineral wealth which lie beneath submerged lands."

If any confirmation of the fact that the state while granting the leases to tidelands still held those lands in its sovereign capacity in trust for the benefit of the public, that confirmation appears from the act itself.

Section 19 of the State Leasing Act provides that all monies received as a result of the leasing of tide-

lands "shall be deposited in the 'general fund'." (1921 Stat., Chap. 303.)

We submit that no valid distinction can be drawn between the status of the Oklahoma leases and the California leases. Can it be said that a state which uses revenues from oil leases for school purposes holds the property in its governmental capacity, while one which holds property in trust for the benefit of the public and turns the revenues derived from the leasing of the same into its general fund does not? The similarity is even more apparent in the case of California, where the monies for public schools are a first lien on the general fund.

> Constitution, Article XIII, Section 15.
>
> "Out of the revenue from State taxes for which provision is made in this article, together with all other State revenues, there shall first be set apart the moneys to be applied by the State to the support of the public school system and the State university."

III.

THE AUTHORITIES CITED BY THE CIRCUIT COURT OF APPEALS DO NOT SUPPORT ITS DECISION.

The Circuit Court of Appeals in rendering its decision relied primarily on

Burnet v. Jergins Trust, 288 U. S. 508, 515, 516.

In that case the City of Long Beach, California, had given Jergins an oil and gas lease on property which it had acquired for a proprietary purpose, namely, for the purpose of securing a water supply. The Court

held that the income received by Jergins was taxable, saying:

> "It was there pointed out that while in one aspect the extent of the exemption must finally depend upon the effect of the tax upon the functions of the government alleged to be affected, still the nature of the governmental agencies and the mode of their constitution may not be disregarded in passing upon the question of tax exemption. An agency may be so intimately connected with the exercise of a power or the performance of a duty by the government that any taxation of it would be a direct interference with the functions of government itself. * * *
>
> "We think that in the present instance *the subject of the tax is so remote from any governmental function* as to render the effect of the exaction inconsiderable as respects the activities of the city. Compare Alward v. Johnson, 282 U. S. 509, 514, 75 L. Ed. 496, 499, 51 S. Ct. 273, 75 A. L. R. 9. Its collection is not inconsistent with and does not trench upon the immunity of the state as a sovereign. The income of the respondent from the lease is not immune from federal income tax."

We will readily concede that oil operations, conducted on land held by a city in a proprietary capacity, are only remotely connected with the performance of an essential governmental function by that city.

South Pasadena v. Pasadena Land and Water Co., 152 Cal. 579,

where the Court said:

> "In administering a public utility, such as a water system, even within its own limits, a city

does not act in its governmental capacity, but in a proprietary and only quasi-public capacity."

Marin Water Co. v. Sausalito, 168 Cal. 587;
Morrison v. Smith Bros., Inc., 211 Cal. 36;
Nourse v. City of Los Angeles, 25 Cal. App. 384.

A municipality, acting in a proprietary capacity, stands on an entirely different basis than when it is performing a governmental function. It loses its sovereign immunity, may be sued without its consent, and is even liable for its torts. In short, it stands in a position very much like that of a private corporation.

The City of Long Beach did not hold its lands in any sovereign capacity or as a trustee as did the United States in *Gillespie v. Oklahoma,* supra, or the state in *Burnet v. Coronado,* supra, and in the instant case.

The Court also referred to

Group No. 1 Oil Corporation v. Bass, 283 U. S. 279,

as authority for its decision. We submit that that decision cannot be considered as a precedent in the instant case. Under Texas law an oil and gas lease is considered as a sale of the oil in place, while in California and Oklahoma a lessee acquires only a profit *a prendre,* or a right to remove the oil.

The distinction was recognized by this Court in

Burnet v. Coronado, supra,

where they said, at page 399, after referring to the *Bass* case:

"As there distinctly indicated, the exemption claimed by the Oil Corporation was denied be-

cause under the settled rule applied by the Texas Supreme Court the oil and gas from disposal of which the corporate income arose had been purchased, not obtained under lease—title had passed out of the State by a present sale. Status of the title was matter for determination under the laws of the State as construed and applied by her courts. In the present cause there is no basis for saying that according to the local law, the transaction between the State and the lessee amounted to a sale."

Similarly there is no basis for saying that the lease from the State of California to Bankline Oil Company amounted to a sale of the oil in place.

Boone v. Kingsbury, 206 Cal. 148, 182.

"The license or privilege or leasehold by which the permittees are granted the right to explore and mine for gas and oil does not constitute a grant or sale of tidelands."

Callahan v. Martin, 3 Cal. (2d) 110, 118.

"We are of the view that an operating lessee under a lease for a term of years, or for a term of years and so long as oil shall be produced in paying quantities, has an interest or estate in real property in the nature of a profit a prendre, which is an incorporeal hereditament."

See also:

Bandini Petroleum Co. v. Superior Court, 110 Cal. App. 123, aff. 284 U. S. 8;

Dabney v. Edwards, 5 Cal. (2d) 1;

Dabney-Johnston Oil Corp. v. Walden, 4 Cal. (2d) 637;

People v. Associated Oil Co., 211 Cal. 93.

CONCLUSION.

In conclusion we submit again that the present case is not distinguishable from *Burnet v. Coronado Oil & Gas Co.* In both cases the state held the leased lands in a governmental capacity and as a trustee for some public purpose.

To exempt the income of a lessee of the State of Oklahoma from federal income tax, and at the same time to levy a tax upon the income of a lessee of the State of California, would be a travesty on justice.

For the reasons set forth, we respectfully submit that the writ of certiorari prayed for by petitioner herein should be granted.

Dated, San Francisco, California,
September 3, 1937.

Respectfully submitted,
A. L. WEIL,
Counsel for Petitioner.

MARTIN J. WEIL,
Of Counsel.

(Appendix Follows.)

Appendix

In the United States Circuit Court of Appeals for the Ninth Circuit

Bankline Oil Company (a corporation), Petitioner, vs. Commissioner of Internal Revenue, Respondent.	No. 8294 Jun. 7, 1937

On Petition to Review an Order of the United States Board of Tax Appeals.

Before: Wilbur, Mathews and Haney, Circuit Judges.

Wilbur, Circuit Judge:

This is a petition for the review of decisions of the United States Board of Tax Appeals entered March 24, 1936 and March 28, 1936 determining a deficiency in petitioners' income taxes of $5,108.71 for the year 1927, of which $3,592.88 has been paid leaving a deficiency of $1,515.83, and a deficiency of $846.94 for the year 1930, of which $825.33 has been paid leaving a deficiency of $21.61, and that there was an overpayment of $65.59 for the year 1928. Petitioner contends that the Board of Tax Appeals should have reduced the deficiency for 1927 by the sum of $2,713.50 and should have determined that there was an overpayment for the year 1928 of $3,598.04 and for the year

1930 of $18,828.04. Petitioner seeks exemption during the taxable year 1930 of all income derived from tide lands situated in the county of Santa Barbara, California, which were leased to petitioner (Note 1) by the state of California for the purpose of producing oil and gas therefrom. Petitioner also claims that the Board erroneously refused to allow it deductions for the years 1927, 1928 and 1930 to which it was entitled because of depletion on its "casinghead gasoline contracts".

As to petitioner's first claim of exemption based upon its income derived from state tide lands:

The State of California holds the tide lands within its boundaries in its sovereign capacity in trust "for the people of the state that they may enjoy the navigation of the waters, carry on commerce over them and have the liberty of fishing therein free from interference of private parties". (Boone v. Kingsbury, 206 Cal. 148, 183. See Constitution of California, Art. 15; Illinois Central R.R.Co. v. Illinois, 146 U.S. 387, see also Rose's U. S. Notes; Borax, Ltd. v. Los Angeles, 296 U.S. 10; Heckman v. Swett, 99 Cal. 303; Oakland v. Buttau, 219 Cal. 745.) The petitioner's lease was granted pursuant to Statutes of California, 1921, ch. 303, p. 404, entitled, "An Act to reserve all minerals in state lands", etc. By this Act, the State has reserved the mineral deposits in all lands belonging to the State

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(Note 1):
By "lease No. 89", the State of California on October 22, 1929, leased the property in question to J. H. Barneson, vice-president and director of petitioner, who acted as agents for petitioner. On November 14th Barneson and his wife assigned all their interest in the lease to petitioner, and on December 19, 1929 the assignment was approved by the State of California.

except lands acquired on a sale for delinquent taxes, unless the deed is required to be filed in the surveyor general's office.

The statute provides for the issuance of prospecting permits (§4). Section 5 of the Act provides that a permittee upon establishing to the satisfaction of the surveyor general that valuable deposits of oil or gas have been discovered within the limits of the land covered by the permit shall be entitled to a lease for one-fourth of the land embraced in the prospecting permit, provided that the permittee shall be granted a lease for as much as one hundred sixty acres. It is provided that "such lease shall be for a term of twenty years upon a royalty of five per centum in amount or value of the production and the annual payment in advance of a rental of one dollar per acre, the rental paid for any one year to be credited against the royalties as they accrue for that year * * *."

Section 6 of the Act provides: "Until the permittee shall apply for lease to the one quarter of the permit area * * * he shall pay to the State of California twenty per centum of the gross value of all oil or gas secured by him from the lands embraced within his permit * * *."

Section 8 of the Act provides for the leasing of unappropriated deposits of oil or gas within the known geologic structure of a producing oil or gas field to the highest bidder, the leases "to be conditioned upon the payment by the lessee of such bonus as may be accepted and of such royalty as may be fixed in the lease, which shall not be less than twelve and one-half per

centum in amount or value of the production, and the payment in advance of a rental of not less than one dollar per acre per annum thereafter during the continuance of the lease, the rental paid for any one year to be credited against the royalties as they accrue for that year".

Section 19 provides: "All moneys received by the surveyor general under the provisions of this act from rents, fees, bonuses and royalties accruing from the use of state school land shall be paid into the 'school fund', all other moneys received under the provisions of this act shall be deposited in the 'general fund'."

One of the purposes of the aforesaid act (Cal. Stat. 1921, ch. 303, p. 404, supra) is to give to the citizens of the state of California, "an opportunity to intercept the large volumes of oil gravitating seaward to inextricable depths, and to reduce to useful purposes oil, gas and mineral depoits reposing beneath the ocean's bed." (Boone v. Kingsbury, 206 Cal. 148, 181, supra.) It was enacted in pursuance of the policy of the State of California "with respect to the extraction of its minerals from state lands", (Boone v. Kingsbury, p. 185, supra). The legislation was upheld by the California Supreme Court against the claim that it violated the implied trust under which the state holds its tide lands because the rights granted by the leases do not interfere with such trust, and do not impair the power of succeeding legislatures to "regulate, protect, improve or develop the public rights of navigation and fishing". (Boone v. Kingsbury, p. 183, supra.)

The federal income tax is not levied on the land so held in trust, nor upon the income of the state derived from the lease of the lands. We are unable to distinguish the situation here from the principle announced by the Supreme Court in Burnet v. Jergins Trust, 288 U.S. 508, where it, in a case involving a tax upon the income derived by a lessee from city owned oil lands held that "the subject of the tax is so remote from any governmental function as to render the effect of the exaction inconsiderable as respect the activities of the city". Mr. Justice Roberts, speaking for the Supreme Court, said:

> "The Revenue Acts do not discriminate between the respondent [lessee] and others similarly situated, in the imposition of the income tax. If the respondent is exempt from the exaction the conclusion must follow because the tax directly burdens the functions of the state acting through the city of Long Beach. Considerations which have led to the condemnation of taxes in other circumstances are here absent. The levy is not upon the property of the municipality, nor upon the income it derives from its property, is not upon the city's share of the oil recovered, the lease, or the gross income therefrom. The law measures the assessment by the net income of the respondent, whose operations are carried on in a private and not in a public capacity for the personal gain of its cestuis ques trustent."

See also, Group No. 1 Oil Corp. v. Bass, 283 U.S. 279.

Petitioner contends that the decision of the Supreme Court in Burnet v. Jergins Trust, supra, is in-

applicable to the case at bar because the lands which were the subject matter of the oil and gas lease in that case had been acquired by the city for the purpose of securing a water supply, and that in operating water works for its inhabitants a city is not exercising its governmental functions. But in Brush v. Commissioner of Internal Revenue, decided by the Supreme Court March 15, 1937, the Supreme Court held that "the acquisition and distribution of a supply of water for the needs of the modern city involve the exercise of essential governmental functions".

On the argument the petitioner attempted to distinguish the situation in the case at bar from that involved in Burnet v. Jergins Trust, supra, on the ground that there the court was dealing with the functions of a municipality of the state while here the state executed the lease in question. This distinction does not seem to be recognized by the authorities which hold that the city, while exercising its governmental functions, is exercising a part of the sovereign power of the state. If so, there can be no distinction in principle between such functions as exercised by the city and by the state. It has been held by the Supreme Court that where the state operates in a proprietary rather than in a governmental capacity its activities are subject to taxation by the federal government. (South Carolina v. U.S., 199 U.S. 437.) It has recently been held in United States v. California, 297 U.S. 175, that where a state is operating in its proprietary, rather than its governmental, capacity it can be penalized by the federal government for violation of federal statute.

We do not place our decision upon the proposition that the state in extracting oil from lands held by it by virtue of sovereignty is acting in a proprietary capacity, particularly where the revenue derived therefrom is utilized in carrying on the governmental functions of the state. The general fund of the state "consists of money received into the treasury and not specifically appropriated to any other fund". (Cal. P. C. §454.) Moneys are disbursed from this fund for public purposes in pursuance of appropriations made by the state legislature. We do not undertake to say whether or not the state is acting in a governmental or proprietary capacity in thus utilizing its state lands. What we do hold is that the tenant who had procured a lease upon such lands for his own profit is liable to taxation upon the net income which he derives therefrom, notwithstanding the fact that his tax liability may tend in some degree to reduce the sum which would otherwise be paid to the state as consideration for the lease. We held to the contrary in Jergins Trust Co. v. Comm'r., 61 F. (2d) 92, relying upon decisions by the Supreme Court in Burnet v. Coronado Oil & Gas Co., 285 U.S. 393; Gillespie v. Oklahoma, 257 U.S. 501; Group No. 1 Oil Corp. v. Bass, 283 U.S. 279. That decision was reversed by the Supreme Court (Jergins v. Comm'r., 288 U.S. 508). The cases which we then cited are now presented by the petitioner in support of its contention that its income derived from the lease of state owned lands is not taxable. We think this case may be distinguished from Burnet v. Coronado Oil & Gas Co., 285 U.S. 393, supra, on the ground that in that case the land and the

oil content thereof had been dedicated by the federal government for school purposes and that the lessee of this land was in effect an agent of the state in applying the proceeds derived from such land to school purposes while in the case at bar there is no restriction upon the right of the state to the use of the moneys derived from the oil lands.

Petitioner's second contention is that it is entitled to an allowance for depletion on its "casinghead gasoline contracts" (Note 2) under the provisions of sections 234 subd. (a)(8), 204 subd. (c)(2), of the Revenue Act of 1926 (44 Stat. 41, 16), and similar provisions contained in the Revenue Act of 1928. (§§23, 114, 45 Stat. 799, 821.)

Petitioner is entitled to a depletion allowance regardless of the technical ownership of the wet gas in place or of the particular legal designation of its interest if by its contracts it obtained an "economic interest" in the gas in place. (Palmer v. Bender, 287 U.S. 551; Helvering v. Falk, 291 U.S. 183; Lynch v. Alworth Stephens Co., 267 U.S. 364; United States v. Biwabik Mining Co., 247 U.S. 116; Signal Gasoline Corp., v. Comm'r., 66 F.(2d) 886; Obispo Oil Co. v. Welch, decided by this court September 28, 1936.)

The rights of petitioner under the "casinghead contracts" on which it seeks a depletion allowance are substantially the same in all the contracts. In these

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(Note 2):

One contract was made by petitioner June 9, 1922 with General Petroleum Corporation.

Three of these contracts were entered into by petitioner on October 25, 1923 with the United Oil Company, one on May 22, 1925 with the Superior Oil Company, and one on October 9, 1928 with the Richfield Oil Company, and are entirely distinct from the state tide land leases considered above.

contracts it was provided that petitioner was entitled to receive for the purpose of extracting gasoline therefrom all the gas produced (with exceptions on some contracts) on the properties of the producers covered by the agreement. The producers agreed to deliver the gas at casingheads or gas traps installed by them on their premises. Petitioner agreed to furnish, install and maintain all pipe lines and connections from the casingheads or gas traps to its plant, and to pay the producers thirty-three and one-third per cent of the total gross proceeds derived from the sale of gasoline extracted from wet gas or at the producer's option, thirty-three and one-third per cent of the gasoline extracted. It was agreed that after the use by petitioner of as much dry gas as it might require for plant operations, and after deductions for waste, not to exceed certain percentages of the gas the producers were entitled to the remaining dry gas.

In Signal Gasoline Corp., v. Comm'r., 66 F.(2d) 886, supra, we held that the taxpayer who had a right to wet gas produced under contracts similar to those in the case at bar had an economic interest in the oil in place entitling it to a depletion allowance. Respondent contends that the contracts in the case at bar are distinguishable from those involved in Signal Gasoline Corp., v. Comm'r., supra; that in that case there was valuable consideration given for the contracts whereas in the case at bar no consideration was given for the contracts. He claims that in Signal Gasoline Corp., v. Comm'r., supra, there were provisions in the contracts there involved requiring the taxpayer to participate in the production of the gas

while in the case at bar the petitioner incurred no obligations in connection with the production of the gas and the production was always controlled by the producer.

The ultimate question to be determined, however, is whether the taxpayer claiming a depletion allowance has an "economic interest" in the oil or gas in place in the properties. It has such an interest if it is entitled to a part of the oil or gas produced from the properties as a part of its capital. (Palmer v. Bender, supra; Helvering v. Falk, supra; Signal Gasoline Corp. v. Comm'r., supra, p. 890; Obispo Oil Co. v. Welch, supra.)

In the majority opinion the Board concluded that the taxpayer in the instant case had no depletable interest in the gas in place. In distinguishing the instant case from the Signal Gasoline Corp. v. Comm'r., 66 F.(2d) 886, it said:

"The court there was convinced that the contracts under consideration and the 'methods employed in reducing the wet gas to possession' created 'an interest in the gas in place or a right to share in the gas produced'. It concluded that the petitioner has the 'requisite economic interest which under the statute entitled it to reasonable allowances for depletion'. We are not so convinced."

This was too narrow a view of what constitutes an economic interest in the oil and gas. Three members of the Board concurred in the result upon the ground that "petitioner has failed to show that the value of wet gas at the mouth of the well purchased under

casinghead gasoline contracts was in excess of the royalties paid therefor and therefore has not shown any proper basis for depletion deductions. Signal Gasoline Corporation, 30 B.T.A. 568, Affd. C.C.A. 9th Cir. 77 F.(2d) 778; Lomita Gasoline Co., 33 B.T.A. 385. * * * Petitioner's failure of proof to show what amount of depletion deductions, if any, it is entitled to take, appears to be similar to that in the cases above cited."

We have heretofore considered the extent of the depletable base of a taxpayer in an oil and gas well. In pursuance of our decision in Signal Gasoline Corp. v. Comm'r., 66 F.(2d) 886, the Board of Tax Appeals, 30 B.T.A. 568, in carrying out the mandate of this court, held that for the purpose of determining the depletion allowance the gross income from the oil property of the manufacturer who produced gasoline from wet gas was the difference between the market value of the wet gas delivered to it less the amount the manufacturer had agreed to pay for it. In dealing with that subject the Board of Tax Appeals said:

"It is well established that a taxpayer may not claim the benefit of a deduction which the statute grants to another. Dalton v. Bowers, 287 U.S. 404; Burnet v. Clark, 287 U.S. 410; Burnet v. Commonwealth Improvement Co., 287 U.S. 415. It follows that the gross income of the lessee from the same production, if any, must be the excess of the fair market value of the wet gas as and when received, over the royalties which it pays under the contracts. * * *

"If the fair market value of wet gas when received by the lessee is not greater than the royalties which it

pays, there is no income of any kind from its property in the leases and, consequently, no gross income that can be used as a basis for computing depletion. In the circumstances herein the petitioner must show that when received by it the wet gas had a fair market value in excess of royalties paid to the lessors. This it has failed to do, and in the absence of such showing we must assume that the fair market value of the wet gas was not in excess of the royalties paid."

This decision correctly states the rule. It was affirmed in Gasoline Corp. v. Comm'r., 77 F.(2d) 728.

Petitioner offered evidence showing that in the tax years in question, the prevailing rate of royalties paid by other refiners of wet gas was higher than that paid by petitioner under its contracts. J. Lee Cross, for over twenty years in the business of making contracts for gasoline and leases with land owners, testified that the prevailing rates of royalty paid on the gasoline extracted from wet gas by casinghead companies in 1927 was 45%, in 1928 47½% and in 1930 50%. T. L. Taggart, contract superintendent of the Standard Gasoline Company whose duty with that company was to make gas processing contracts, testified that the royalty paid in 1927 was 43%, in 1928 45%, and in 1930 47%. John McFarland, in charge of the contract department of the Gilmore Oil Company, testified that the royalty paid in 1927 was 45%, in 1928 50%, and in 1930 50%. F. K. Baxter, witness for respondent, and engineer revenue agent with the Internal Revenue Bureau, testified:

"There is no question but the royalty rate increased from 1923 to 1928. In 1923 there were more at 33⅓%

than there were at less than 33⅓%. That was the usual rate in 1923—33⅓%. Gradually the rate has increased, as has been testified to here, and up to 37½% and 40 to 45 and up to 50."

Respondent contends in his brief, however, that "a rise in royalty rates does not establish the value of petitioner's wet gas at the mouth of the well, and certainly does not prove that the value of the interest acquired exceeded what petitioner had to pay for it", that "in proving comparatives it must be shown that the basis of comparison is the same"; that petitioner failed to put in evidence any of the contracts of any other producers in the same field which contracts might have contained provisions different from petitioner's and justifying the refiner in paying a higher rate of royalty. Respondent contends, for example, that the contracts used for comparison may have contained no provision for the return of dry gas to the producer. He further contends that petitioner "failed to prove that the prevailing rates were upon wells producing the same gasoline content as the wells in petitioner's contracts", that the royalty rate would be higher on a well producing gas of a high gasoline content, than on one producing gas of a low gasoline content.

In establishing a rise in the market price of wet gas petitioner was forced to rely on prevailing royalty rates under contracts similar to the contracts in the case at bar for it is clear from the record that in California wet gas is not sold for a price per unit at the mouth of the well. It is apparent from the testimony that the contracts used as a basis of comparison by

the witnesses who testified to the rise in the prevailing royalty may be sufficiently similar to petitioner's contracts to make their testimony a fair criterion by which to determine whether petitioner under its contracts had a right to gas below its market value.

J. Lee Cross testified:

> "I know about the operation of a casinghead gas plant, and I made contracts similar to those involved in this case.
>
> It is not a fact that there are two general types of contracts. The gasoline company acts the same under all contracts, and assumes all contracts are as one. While firms may have worded them differently, they are operated on exactly the same by all absorption plants. I have worked for pretty nearly half of the absorption plants. I make no distinction in a contract providing for the purchase and sale of gas, and one merely providing for the treatment of it; they are all processing contracts. * * *
>
> Generally the contracts provide that after the extraction of the gasoline, the dry gas is returned to the producer. * * *
>
> I am familiar with the general type of casinghead gas contracts entered into for extraction of gasoline in which the owner of the casinghead plant goes to an operator and says that he would treat his gas for so much royalty."

The testimony of respondent's witness F. K. Baxter is not substantially different from that of Cross. He testified:

> "I am familiar with the types of casinghead contracts used by the various operators. There are several types of those contracts. When I

say type, I mean changes in wording. There is one type which says that the producer agrees to sell and the casinghead man agreed to buy. The other merely provides for the treatment of gas. * * *

In some of the contracts with which I am familiar, the dry gas belongs to the casinghead contractor, while in other cases it belongs to the producer, and is sold under his instructions. * * *

In my experience I found two broad types of contract—the gas treatment and the purchase and sale contract. The casinghead man accounts to the operator of the well for the dry gas sold.

It is usually provided that a substantial part of the dry gas, between 66⅔ and 75%, remains the property of the producer. * * *"

As we have pointed out, the testimony of this witness as well as that of witnesses for petitioner, was that there was a rise in the royalty rates in the years in question. The inference from this testimony is that the contracts upon which they based their conclusion were substantially the same.

As to respondent's contention that the royalty rate paid on a well that produced more gasoline per cubic feet of gas would be higher than on one producing less, it is sufficient to say that there is testimony to the contrary. J. Lee Cross testified on that subject as follows:

"It makes no difference whether the gas is rich or lean, whether you have a half gallon or four or five gallons. The royalty rate is just the same.

Ninety to ninety-five per cent of the extraction contracts are made before the wells are brought in."

In considering the decision of the Board of Tax Appeals under review the contention of the taxpayer may be more succinctly shown by reference to the amounts it claims for depletion. We quote from its brief in that regard as follows:

> "* * * if petitioner's contentions are correct, it is entitled to an allowance for depletion computed in the following manner:

	Value of Gasoline Recovered	Contract Royalty	Prevailing Royalty	Depletable Interest	Depletion
1927	626,494.68	208,831.67	281,922.61	73,090.93	20,100.00
1928	769,633.55	256,544.33	365,575.94	109,031.61	29,983.69
1930	390,596.48	130,257.68	195,298.24	65,040.56	17,886.15
				$247,163.11	67,969.84

In the foregoing statement the petitioner assumes that the evidence has established the values stated as "prevailing royalty" and that such "prevailing royalty" was the market value of the wet gas delivered to it, and that its "depletable interest" amounts in all to $247,163.11 for the three years 1927, 1928 and 1929, which represents the difference between the royalty it had agreed to pay under its contracts referred to as "contract royalty" and the market value of wet gas as established by the "prevailing royalty". The method of establishing values is a fact-finding and not a mathematical process. The Board of Tax Appeals was not obliged to accept the testimony as to the "prevailing royalties" as conclusive evidence of market value. The process of arriving at market value is a judicial process and requires that in weighing the evidence the credibility of witnesses should be considered and that in determining market value there should be an independent exercise of

judgment as to value. It is true that the majority of the Board found that wet gas "as it flows from the earth is not a salable commodity". It does not follow, however, that it does not have a market value because it is invariably purchased by manufacturing concerns under royalty agreements for the production of casing-head gasoline, although it is not sold at a price per unit.

If, for the purpose of determining the taxpayer's gross income from the property, we attempt to fix the difference between the market value of the wet gas and the contract value thereof, we would invade the fact-finding jurisdiction of the Board of Tax Appeals. It is clear that a majority of the Board bases its decision against the taxpayer in part at least upon the ground that the nature of the taxpayer's contract is such that he would not be entitled to depletion, regardless of the question of whether or not its contract is so favorable that there was or may have been a difference between the price paid for wet gas in terms of gasoline and its market value. In this regard we think the majority of the Board erred, and that in the case at bar, having to deal with the contract under which the taxpayer was entitled to all the wet gas produced from the wells so long as any was produced, it should have ascertained whether or not it had any economic interest in the gas in place, and if so the amount of depletion to be allowed.

As we have pointed out the evidence in the case all tends to show that by reason of the change in royalty rates the petitioner had a definite economic interest in the oil in place upon which it was entitled to an allow-

ance for depletion. The extent of that right and the depletion allowance thereon is a question of fact to be determined by the Board of Tax Appeals upon the evidence before it.

In fixing the depletion allowance it is not sufficient to establish the taxpayer's gross income from the property and estimate the depletion allowance at 27½ per cent thereof. It is necessary also for the taxpayer to show that this percentage does not exceed one-half of the net income from the property, unless the taxpayer claims a greater allowance for depletion than one-half of the net income in which event he must establish that it would be more if computed without reference to the two percentages above mentioned. (Par. 2, of §204(c) of the Revenue Act of 1926, 44 Stat. 16.) The record herein does not clearly show that the taxpayer offered evidence as to the net income from the property. It apparently assumed that there was no expense of the taxpayer incident to the production of the wet gas received by it and that the net income and the gross income from the property were identical. The figures it uses in claiming depletion allowance above set forth would so indicate. As this deficiency in the proof was not the basis of the decision by the Board of Tax Appeals we feel that the taxpayer should be accorded the right to supplement its proof on that subject and that the Board of Tax Appeals should make such an allowance for depletion as in its judgment is in accord with the evidence under the law as herein decided.

The decision of the Board is affirmed as to the non-exemption of the income of the petitioner derived from leases of petitioner on state owned tide lands,

and reversed as to the disallowance for depletion on its casinghead gasoline contracts with instructions to allow additional evidence as to depletion, and to fix the allowance in accordance herewith.

Haney, Circuit Judge, concurring.

I concur in that portion of the opinion prepared by Judge Wilbur which affirms a portion of the Board's decision.

I concur in reversal, but I express a substantial doubt that "wet gas", with respect to which the Board found "as it flows from the ground is not a salable commodity", can have a market value.

(Endorsed:) Opinion and Concurring Opinion. Filed Jun. 7, 1937. Paul P. O'Brien, Clerk.

In the Supreme Court of the United States

OCTOBER TERM, 1937

No. 388

BANKLINE OIL COMPANY, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

We do not oppose the granting of a writ of certiorari in this case.

The question presented is whether the income which petitioner realized as assignee of an oil and gas lease granted by the State of California is immune from the Federal income tax. The court below held that the doctrine of immunity did not apply. We believe that the decision is correct and in harmony with the trend of decisions. However, we think it our duty to call the Court's attention to the decision of the Circuit Court of Appeals for the Tenth Circuit in *Mountain Producers Corp.* v. *Commissioner*, announced on August 26, 1937, not

yet reported, but may be found in 1937 Prentice-Hall, vol. 1, par. 1559. While that case is not referred to in the petition, it is apparently in conflict with the decision below. In the *Mountain Producers* case the lessee of state school lands had made a declaration of trust in which it undertook to hold an undivided 50 per cent interest in the oil lease for the benefit of a subsidiary of the taxpayer. The Circuit Court of Appeals for the Tenth Circuit, Judge Phillips dissenting, held the income exempt from taxation by the United States.

The situation, in short, is that the Circuit Court of Appeals for the Tenth Circuit has followed *Gillespie* v. *Oklahoma,* 257 U. S. 501 and *Burnet* v. *Coronado Oil & Gas Co.,* 285 U. S. 393, while the court below has followed *Burnet* v. *A. T. Jergins Trust,* 288 U. S. 508. We believe the resulting decisions are in substantial conflict,[1] and that an important field of the intergovernmental tax immunity doctrine is in need of clarification. It is probable that the decision in this case can be reconciled with the *Mountain Producers* case on the ground suggested in the *A. T. Jergins* case, where the Court distinguished the *Gillespie* and *Coronado* cases on the ground that the government lands were in those cases held pursuant to an express trust (p. 516). In the present case, the lands are tide lands

[1] We also believe that the *Mountain Producers* case should, in any event, have been decided for the Government because the taxpayer's subsidiary was not the lessee of the state lands, and had direct contractual relations only with the private lessee of the lands.

owned by the State of California in its sovereign capacity and its trusteeship is implied rather than expressed. In the *Mountain Producers* case the State of Wyoming leased lands granted by the United States to the State for the maintenance of its schools. It is possible that the title of the State of Wyoming may be more akin to that of an express trustee than is that of the State of California in the present case. But we do not believe that this distinction can properly be given controlling weight; the doctrine of intergovernmental tax immunity is designed to protect governmental functions whether the Government acts as such or as a trustee. We agree with petitioner (Br. 16) that it should make no difference whether the proceeds of the oil leases are paid directly into a school fund or are paid first into the general fund and then used for the maintenance of the public schools.

Because of the apparent conflict, and the fact that respondent has filed a petition for certiorari seeking a review of the decision below on another issue (*Guy T. Helvering, Commissioner of Internal Revenue* v. *Bankline Oil Company,* No. 387, October Term, 1937), respondent does not oppose the issuance of a writ of certiorari.

Respectfully submitted.

STANLEY REED,
Solicitor General.

OCTOBER 1937.

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IN THE

SUPREME COURT
OF THE
UNITED STATES.

October Term, 1937

No. 388.

BANKLINE OIL COMPANY, a corporation,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

BRIEF FOR THE PETITIONER.

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IN THE

SUPREME COURT

OF THE

UNITED STATES.

October Term, 1937

No. 388.

BANKLINE OIL COMPANY, a corporation,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF FOR THE PETITIONER.

Statement Disclosing Basis of Jurisdiction.

(a) The statutory provision sustaining the jurisdiction of this Court is conferred by Section 240-(a) of the Judicial Code, as amended by the Act of February 13, 1925.

(b) The opinion of the Board of Tax Appeals [R. 42-56] is reported in 33 B. T. A. 910.

(c) The judgment of the Circuit Court of Appeals was entered June 7, 1937 [R. 154] and is reported in 90 Fed. (2d) 899. [R. 144-154.]

(d) Petition for certiorari was filed September 7, 1937 and was granted October 25, 1937.

Question Presented.

Is the income of a lessee of State tide lands under an oil and gas lease, in which the State reserves a royalty, subject to Federal income taxes under the Revenue Act of 1928?

Statement of the Case.

This action was instituted by petitioner in the United States Board of Tax Appeals for the recovery of certain overpayments in income tax made by petitioner for the calendar yars 1927, 1928 and 1930. It involvd two entirely separate and unrelated questions.

In so far as the question involved in this petition is concerned, the suit was brought for the recovery of income taxes charged against petitioner for the year 1930 upon income derived by petitioner from an oil and gas lease from the State of California.

The facts applicable to the particular question involved in this petition are entirely without dispute. In fact, they were the subject of a stipulation entered into between counsel for petitioner and counsel for the Commissioner of Internal Revenue prior to the hearing before the Board of Tax Appeals. [R. 73, 74.]

On October 22, 1929, the State of California, pursuant to Chapter 303, Statutes of California, 1921, approved May 21, 1921, entitled "An Act to Reserve all Minerals in State Lands, etc.", leased certain oil and gas lands situated in the County of Santa Barbara, State of California, to H. J. Barneson, reserving to itself a royalty. The lease covered lands situated below the tide line, and is known as Lease No. 89, or the Elwood Lease.

The statute referred to provides in Section 4 for the issuance of prospecting permits. Section 5 of the Act provides that a permittee, upon establishing to the satisfaction of the Surveyor General that oil and gas in commercial quantities has been discovered on the permit lands, shall be entitled to a lease on the lands embraced in the permit. The section further provides that

> "such lease shall be for a term of twenty years upon a royalty of five per centum in amount or value of the production * * *."

The Act also provided that prior to the issuance of a lease the lessee

> "shall pay to the State of California twenty per centum of the gross value of all oil or gas secured by him from the lands embraced within this permit * * *."

At the time of the issuance of the lease, Barneson was a vice-president and director of petitioner and was acting on its behalf in acquiring the lease. On November 14, 1929, Barneson and his wife assigned all of their right, title and interest to the lease to Bankline Oil Company. This assignment was approved by the State of California on December 19, 1929.

On acquiring the lease, petitioner immediately commenced drilling operations. Those operations were successful and resulted in the discovery of oil which petitioner produced during all of 1930. During 1930 its net income as a result of the production from Lease No. 89 was $139,014.28.

Specification of Error.

Your petitioner respectfully submits that the Circuit Court of Appeals committed error in refusing to follow the decision of this Court in *Burnet v. Coronado Oil & Gas Co.*, 285 U. S. 393, and in determining that the income of petitioner as the lessee of oil and gas lands from the State of California was subject to taxation under the Revenue Act of 1928.

Summary of Argument.

In support of its contention petitioner presents the following propositions of law:

1. A tax upon the income of a lessee of State tide lands, under an oil and gas lease reserving a royalty to the State, is a tax upon an instrumentality of the State and is therefore improper.

2. The State of California holds its tide lands in a governmental capacity in trust for the benefit of the general public.

3. This Court in deciding *Burnet v. Jergins Trust*, 288 U. S. 508, did not, and did not intend to, overrule its decision in *Burnet v. Coronado Oil & Gas Co.*, 285 U. S. 283.

I.

A Tax Upon Appellant's Income From Lease No. 89 Is a Tax Upon an Instrumentality of the State of California and Is Unconstitutional.

(a) The United States May Not Levy an Income Tax Upon an Instrumentality of a State.

One of the primary principles, upon which the Constitution of the United States was founded, was that there should be a division of powers between the United States on the one hand and the several sovereign states on the other. In order to carry out that principle, it was established very early in our judicial history that neither a State nor the United States could tax the property, or the governmental agencies or instrumentalities of the other.

M'Culloch v. Maryland, 4 Wheat. 316;

Weston v. Charleston, 2 Pet. 449;

The Collector v. Day, 11 Wall. 113;

Northwestern Mutual Life Insurance Co. v. Wisconsin, 275 U. S. 136;

Macallen Co. v. Massachusetts, 279 U. S. 620;

Indian Motocycle Co. v. United States, 283 U. S. 570.

Thus it has been that a state cannot tax government bonds either by levying an *ad valorem* tax,

Weston v. Charleston, 2 Pet. 449;

or a gross income tax,

Northwestern Mutual Life Insurance Co. v. Wisconsin, 275 U. S. 136;

or a net income tax,

Macallen Co. v. Massachusetts, 279 U. S. 620;

Pollack v. Farmers Loan & Trust Co., 157 U. S. 429.

For like reasons the United States may not tax the salary of an officer of the state.

Buffington v. Day, 11 Wall. 113.

Nor may either the state or the Federal government levy sales or excise taxes upon persons selling commodities to the other.

Panhandle Oil Co. v. United States, 277 U. S. 218;

Indian Motocycle Co. v. United States, 293 U. S. 570;

Graves v. Texas Company, 298 U. S. 393.

The principle underlying this rule is that a tax by the United States upon one of the instrumentalities of a state is a direct burden upon and an interference with the state's exercise of its sovereign powers.

As stated by this Court in the early case of

Weston v. Charleston, 2 Pet. 449, 465, 468, 469:

"The tax in question is a tax upon the contract subsisting between the Government and the individual. It bears directly upon that contract while subsisting and in full force . . .

"The right to tax the contract to any extent, when made, must operate upon the power to borrow before it is exercised, and have a sensible influence on the contract. The extent of this influence depends on the will of a distinct Government. To any extent,

however inconsiderable, it is a burden on the operations of Government . . .

"The tax on Government stock is thought by this Court to be a tax on the contract, a tax on the power to borrow money on the credit of the United States and consequently to be repugnant to the Constitution."

Though the tax may be in form upon a private individual, it is still unconstitutional if it has the effect of burdening a transaction in which the state is involved.

Panhandle Oil Co. v. Mississippi, 277 U. S. 218, 222:

"It is immaterial that the seller and not the purchaser is required to report and make payment to the state. Sale and purchase constitute a transaction by which the tax is measured and on which the burden rests . . .

"The necessary operation of these enactments when so construed is directly to retard, impede, and burden the exertion by the United States, of its constitutional powers to operate the fleet and hospital."

See, also:

United States v. Baltimore & Ohio R. R. Co., 17 Wall. 322.

Another factor ignored in cases of this type is the extent of the burden. Unlike cases on interstate commerce, if the interference exists the ban is absolute, despite the fact that the burden imposed is not great.

Indian Motocycle Co. v. United States, 283 U. S. 570, 575:

"Where the principle applies it is not affected by the amount of the particular tax or the extent of the resulting interference, but is absolute."

However, the only ones who may claim the exemption are those who are acting as instrumentalities of the Government. The exemption does not extend to independent contractors who, for an agreed consideration, have undertaken to perform certain work on behalf of the Government.

Metcalf v. Mitchell, 269 U. S. 514;

Alward v. Johnson, 282 U. S. 509;

James v. Dravo Contracting Co., 82 L. Ed. Adv. Op. 125.

As has been frequently pointed out, the line of distinction is frequently hard to draw but the Court can and does draw such a line.

(b) PETITIONER, AS OPERATOR OF LEASE NO. 89 FOR THE STATE OF CALIFORNIA, IS ACTING AS AN INSTRUMENTALITY OF THE STATE.

The question of into what category the lessee of a state or of the United States falls is not a new question for this Court to decide. On several occasions it has been presented to this Court for decision. In each case the Court has held that a person who holds an oil and gas lease from a state or from the United States under an agreement whereby the governmental lessor reserves a royalty or a share of the production, the lessee is an instrumentality of the state.

Gillespie v. Oklahoma, 257 U. S. 501, 504, 506:

"The lessee was an instrumentality used by the United States in carrying out duties to the Indians that it had assumed . . .

"The same considerations that invalidate a tax upon the leases invalidate a tax upon the profits of the leases; and, stopping short of theoretical possibilities, a tax upon such profits is a direct hamper upon the effort of the United States to make the best terms that it can for its wards."

Jaybird Mining Co. v. Weir, 271 U. S. 609, 613:

"The lessee is an agency or instrumentality employed by the Government for the development and use of the restricted land and to mine ores therefrom for the benefit of its Indian wards."

Chocktaw R. R. Co. v. Harrison, 235 U. S. 292, 298:

"Appellant is the instrumentality through which this obligation is being carried into effect. Such an agency cannot be subjected to an occupation or privilege tax by a state."

See, also:

Indian Territory Illuminating Oil Co. v. Oklahoma, 240 U. S. 522,

in which the Court rejected the contention of the state that such a lessee was an independent contractor.

In

Burnet v. Coronado Oil & Gas Co., 285 U. S. 393, 400;

a case virtually identical with the instant case, this Court held that a Federal income tax upon the income of a lessee under a state oil and gas lease was an interference with the state's exercise of its sovereign powers.

The state of Oklahoma had issued an oil and gas lease to the Coronado Oil and Gas Co. The United States sought to levy an income tax upon the income derived by the Coronado Oil and Gas Co. from that lease. The Supreme Court held that that portion of the company's income that was received from the state lease was exempt from taxation, saying:

> "When Oklahoma undertook to lease her public lands for the benefit of the public schools she exercised a function strictly governmental in character
>
> . . .
>
> "Here the lease to the respondent was an instrumentality of the State for the purpose of carrying out her duty in respect of public schools. To tax the income of the lessee arising therefrom would amount to an imposition upon the lease itself."

See, also:

> *Mountain Producers Oil Corp. v. Commissioner,* 92 Fed. (2d) 78 (C. C. A. 10).

In order to induce a person or a corporation to prospect lands for oil, a landowner must offer his prospective lessee an opportunity to make a reasonable profit from his operations, should they be successful. The drilling of oil wells, particularly on tide lands, is a very expensive proposition. The risk is great, for there is always the possibility that a well will be dry, in which event the entire investment is lost. Consequently, no person would undertake such a venture unless he was assured that, if his efforts were crowned with success, he would make a sufficient profit to

compensate him for the risk involved. One of the important elements considered by a prospective lessee who is trying to estimate his possible return on a particular lease, is the amount of royalties he will have to pay to his landowner.

The exemption from taxation of the profits derived from oil operations on state lands has a direct bearing upon the amount of royalties which the state, as landowner, can exact from its lessees. If the income of the state's lessee is exempt from Federal income taxes, the state would be in a position to charge its lessees a higher royalty than it could otherwise collect. Economically the lessee could afford to increase the royalty paid to the state by the amount which he would otherwise be required to pay as income taxes. To put it in another way, if the state's lessee were required to pay income taxes to the United States, his ultimate margin of profit, out of which his royalties would be paid, would be reduced. The amount of royalties he could afford to pay would be similarly reduced, and the state would suffer to that extent.

We submit that the tax in question is a direct interference with the means used by the state to develop its natural resources.

Petitioner is in very much the same position as a holder of municipal bonds. The purchaser of bonds lends money to his state and in return receives a profit on his investment in the form of interest. Petitioner, as a lessee of State tide lands, advanced money for the purpose of drilling oil wells for the State. When the venture was successful petitioner made a profit.

In both cases an income tax upon those profits is unconstitutional. Just as a tax upon the income from state bonds

> "would operate on the power to borrow before it is exercised, and would have a sensible influence on the contract."
>
> *Pollack v. Farmers Loan & Trust Co.*, 157 U. S. 429, 586;

so a tax upon the income of the lessee of the State would operate on the power of the State to make a lease before it is exercised.

We submit that the income tax which the United States seeks to impose upon petitioner is a direct interference with the means used by the State to develop its natural resources.

In addition to constituting such an interference with the functioning of the State, the tax is in effect a tax upon real property owned by the State of California. It has long been recognized that a tax upon the rents and profits of realty is, in effect, a tax upon the land.

> *Pollack v. Farmers Loan & Trust Co.*, 157 U. S. 429.

We believe that it is apparent from the foregoing that the tax here in question is a tax upon real property owned by the State of California and upon the lease from the State to petitioner. That lease being an instrumentality of the State, the tax imposes a burden upon that instrumentality and is, therefore, an unconstitutional levy.

> *Burnet v. Coronado Oil & Gas Co.*, 285 U. S. 393.

II.

The State of California Holds Its Tidelands in Trust for the Benefit of the People.

When the original thirteen states joined together to form the Union, title to tidelands was reserved to them. Similarly, when California was admitted to the Union title to the tide lands bordering on its shores passed from the United States, which had held them since they were acquired from Mexico, to the state.

Borax Consolidated v. City of Los Angeles, 296 U. S. 10.

Those lands are held by the State in trust for the benefit of the people.

Illinois Central Railroad Co. v. Illinois, 146 U. S. 387.

This Court, in referring to the lands under the navigable water of Lake Michigan, said:

> "But it is a title different in character from that which the state holds in lands intended for sale. It is different from the title which the United States holds in the public lands which are open to pre-emption and sale. It is a title held in trust for the people of the state." (p. 452.)

And a little later, on page 453, referring to the disposal of these lands, they continued:

> "Such abdication is not consistent with the exercise of that trust which requires the government of the state to preserve such waters for the use of the public.

The trust devolving upon the state for the public, and which can only be discharged by the management and control of property in which the public has an interest, cannot be relinquished by a transfer of the property. *The control of the state for the purposes of the trust can never be lost.* . . ." (Italics ours.)

Heckman v. Sweet, 99 Cal. 303:

"Navigable streams and the shores to ordinary highwater mark are held by the state in trust for the public;"

Ward v. Mulford, 32 Cal. 365, 372:

"The land which the state holds by virtue of her sovereignty, as is well understood, is such as is covered and uncovered by the flow and ebb of the neap of ordinary tides. Such land is held by the state in trust and for the benefit of the people."

See, also:

Oakland v. E. K. Wood Lumber Co., 211 Cal. 16, 23;

Boone v. Kingsbury, 206 Cal. 148;

People v. Goldrun Mining Co., 66 Cal. 138, 151.

Inasmuch as the foregoing rule is a rule of property in California, the Federal Courts will follow the rule as adopted by the Courts of California.

United States v. Mission Rock Co., 189 U. S. 391.

While the state may dispose of its property to private individuals, it can only do so when the use to which the individual proposes to put the property is for the benefit of, and not inconsistent with, the public trust on which the property is held by the state.

Weber v. State Harbor Commissioners, 18 Wall. 57;

Boone v. Kingsbury, 206 Cal. 148;

Forestier v. Johnson, 164 Cal. 24;

Heckman v. Swett, 99 Cal. 303;

Taylor v. Underhill, 40 Cal. 471.

In

Boone v. Kingsbury, 206 Cal. 148, 181, 182, 184,

the California Supreme Court had under consideration the constitutionality of the very act under which Lease No. 89 was issued by the State to petitioner. That Court held that the State had power to issue leases to State tide lands and that the granting of such leases did not affect in any way the title of the State and did not alter the trust capacity in which the State held the property.

"It is clear that one of the purposes of the Legislature by the enactment of said chapter 303, Statutes and Amendments of 1921, page 404, was to give to the citizens an opportunity to intercept the large volumes of oil gravitating seaward to inextricable depths, and to reduce to useful purposes oil, gas and mineral deposits reposing beneath the ocean's bed. . . .

"The license or privilege authorizing the permittee to prospect and mine tide-lands is denominated by the act a lease, but in practical effect it strongly partakes of the character of a contract to prospect or mine

said tide-lands on a share or percentage basis. In no sense does the state part with title to its tide-lands. . . .

"The license or privilege or leasehold by which the permittees are granted the right to explore and mine for gas and oil does not constitute a grant or sale of tide-lands in the sense that those terms are used in the prohibitory provisions of article XV, section 3, State Constitution."

If any confirmation of the fact that the State, while granting the leases to tidelands, still held those lands in its sovereign capacity in trust for the benefit of the public, that confirmation appears from the act itself.

Section 19 of the State Leasing Act provides that all monies received as a result of the leasing of tide lands "shall be deposited in the 'general fund'." (1921 Stat., Chap. 303.)

We submit that no valid distinction can be drawn between the status of the Oklahoma leases and the California leases. Can it be said that a state which uses revenues from oil leases for school purposes holds the property in trust, while one which holds property in trust for the benefit of the public and turns the revenues derived from the leasing of the same into its general fund does not? The similarity is even more aparent in the case of California, where the monies for public schools are a first lien on the general fund."

Constitution, Article XIII, Section 15:

"Out of the revenue from State taxes for which provision is made in this article, together with all other State revenues, there shall first be set apart the moneys to be applied by the State to the support of the public school system and the State university."

III.

The Authorities Cited by the Circuit Court of Appeals Do Not Support Its Decision.

The Circuit Court of Appeals, in rendering its decision, relied primarily upon

Burnet v. Jergins Trust, 288 U. S. 508, 516.

In that case the City of Long Beach, California, had given to Jergins an oil and gas lease on property which the city had purchased for use in connection with its water system, but was not being so used. The lessee sought to establish that the income he received from the lease was immune from taxation under the Federal Revenue Acts.

The Court denied him the immunity claimed and distinguished *Gillespie v. Oklahoma, supra*, and *Burnet v. Coronado, supra*, saying:

> "The respondent relies upon *Gillespie v. Oklahoma*, 257 U. S. 501, 66 L. Ed. 338, 42 S. Ct. 171, and *Burnet v. Coronado Oil & Gas Co.*, 285 U. S. 393, 76 L. Ed. 815, 52 S. Ct. 443, as authorities binding upon us and requiring a decision in its favor. *In both of those cases the sovereign was acting as the trustee of an express trust with regard to the lands leased.* In both the burden upon the public use was more definite and direct than in the present case. As said in the Coronado Oil & Gas Co. case, the doctrine of Gillespie v. Oklahoma is to be applied strictly and only in circumstances closely analogous to those which it disclosed. The decisions relied on cannot be held to be authority upon the facts presented by this record." (Italics ours.)

No such distinction may be drawn in the instant case. As we have already pointed out, the State of California holds its tide lands in trust for the benefit of the public. Such a trust can not stand in a different category than the trust that existed in *Gillespie v. Oklahoma, supra,* and in *Burnet v. Coronado, supra.* The petitioner here is entitled to the same exemption as the lessees in the cases cited, for the burden upon the public use is just as definite and direct. We, submit, therefore, that the decision in the instant case cannot be controlled by *Burnet v. Jergins Trust, supra,* for the reason the element of public trust, lacking there, is found in the case at bar.

The Circuit Court also referred to

Group No. 1 Oil Corporation v. Bass, 283 U. S. 279,

as an authority for its decision. We submit that that decision cannot be considered as a precedent in the instant case. Under Texas law an oil and gas lease is considered as a sale of the oil in place, while in California and Oklahoma a lessee acquires only a profit *a prendre,* or right to remove the oil.

The distinction was recognized by this Court in

Burnet v. Coronado, supra,

where the Court said, at page 399, after referring to the *Bass* case:

> "As there distinctly indicated, the exemption claimed by the Oil Corporation was denied because under the settled rule applied by the Texas Supreme Court the oil and gas from disposal of which the corporate income arose had been purchased, not obtained under

lease—title had passed out of the State by a present sale. Status of the title was matter for determination under the laws of the State as construed and applied by her courts. In the present cause there is no basis for saying that according to the local law, the transaction between the State and the lessee amounted to a sale."

Similarly there is no basis for saying that the lease from the State of California to Bankline Oil Company amounted to a sale of the oil in place.

Boone v. Kingsbury, 206 Cal. 148, 184.

"The license or privilege or leasehold by which the permittees are granted the right to explore and mine for gas and oil does not constitute a grant or sale of tide lands."

Callahan v. Martin, 3 Cal. (2d) 110, 118.

"We are of the view that an operating lessee under a lease for a term of years, or for a term of years and so long as oil shall be produced in paying quantities, has an interest or estate in real property in the nature of a profit *a prendre,* which is an incorporeal hereditament."

See, also:

Bandini Petroleum Co. v. Superior Court, 110 Cal. App. 123, Aff'd. 284 U. S. 8;

Dabney v. Edwards, 5 Cal. (2d) 1;

Dabney-Johnston Oil Corp. v. Walden, 4 Cal. (2d) 637;

People v. Associated Oil Co., 211 Cal. 93.

Conclusion.

In conclusion we submit again that the present case may not be distinguished from *Burnet v. Coronado Oil & Gas Co., supra,* or from *Gillespie v. Oklahoma, supra.* In all three cases the state held the leased lands as a trustee for a public purpose. Those purposes were substantially similar.

To exempt the income of a lessee of the State of Oklahoma from Federal income tax and, at the same time, to levy a tax upon the income of a lessee of the State of California, would be a travesty on justice.

We therefore submit that the $139,014.28 derived by petitioner from its operations as a lessee of the State of California on Lease No. 89 is not subject to taxation under the Federal Revenue Laws, and that petitioner is entitled to a refund of $16,681.71.

Dated, Los Angeles, California, January 22, 1938.

Respectfully submitted,

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